Petition

Office-Supreme Court, U.S.
FILED
AUG 19 1981
ALEXANDER L. STEVAS,
CLERK

81-348
No.

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1981

HARRY T. and MARY HOLGERSON, JR.,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Once he has exercised his discretionary authority under Section 446 of the Internal Revenue Code (the "Code") to approve or disapprove a particular method of accounting and under Section 7805(b) of the Code to make the effect of a Revenue Ruling nonretroactive, may respondent disregard such exercise of his statutory authority, or is he bound thereby under the rule expressed in State Bank of Albany v. United States, 530 F.2d 1379 (Ct. Cl. 1976)?

2. Should a Revenue Ruling of general applicability, issued by respondent, be interpreted narrowly against taxpayers who acted in reliance on the ruling, or according to the everyday meaning of its words?

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PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
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Petitioners Harry T. Holgerson, Jr. and Mary Holgerson respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United

States Court of Appeals for the Ninth Circuit entered in this proceeding on January 30, 1981.

OPINIONS BELOW

The opinion of the Court of Appeals (App. A, infra) as amended by that Court's order filed May 21, 1981 denying petitioners' Petition for Rehearing (App. B, infra), is reported at 638 F.2d 104. The original opinion of the Court of Appeals (App. C, infra) was entered on January 30, 1981 and is not reported. The opinion of the United States Tax Court (App. D, infra) was entered on December 12, 1977 and is reported at 69 T.C. 440 under the name of Paul F. Roemer, Jr. and Marcia E. Roemer, et al. v. Commissioner of Internal Revenue.

JURISDICTION

The opinion of the Court of Appeals for the Ninth Circuit was filed on January 30, 1981. A timely petition for rehearing was denied on May 21, 1981. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1966).

STATUTORY PROVISIONS

The relevant statutes are Sections 163(a), 446(b), 461(g), 481, 1311, 7442, 7482, and 7805 of the Internal Revenue Code of 1954, as amended (App. E, infra), and the relevant regulations are Treasury Regulations Sections 1.446-1, 1.461-1(a)(3), 601.601(a) and (d) (App. F, infra).

STATEMENT OF THE CASE

This case raises unresolved questions concerning the ability of taxpayers to rely upon official published

interpretations of the tax laws by the Internal Revenue Service. These questions are critical both to the administration of the tax laws and to the operation of other administrative agencies. The questions arise from two pronouncements of the Commissioner of Internal Revenue, I.T. 3740, 1945 C.B. 109 (App. G, infra), and Revenue Ruling 68-643, 1968-2 C.B. 76 (App. H, infra).

In I.T. 3740, the Commissioner stated that "[i]nterest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes. . . ." The ruling relied upon several prior cases which had held prepaid interest to be deductible. See, e.g., John D. Fackler, 39 B.T.A. 395 (1939), acq. 1939-1 C.B. 11; Court Holding Co.,

2 T.C. 531 (1943), aff'd on other issues, 143 F.2d 823 (5th Cir. 1944), aff'd 324 U.S. 331 (1945), acq. 1943 C.B. 5. In I.T. 3740, the Commissioner made specific reference to Section 29.43-2 of former Treasury Regulation 111 which stated that the expenses of one year could not be used to reduce the income of another year, so that if a taxpayer did not deduct his expenses in the proper year, he could not deduct them from his income in the next or any subsequent year.

In Revenue Ruling 68-643, 1968-2 C.B. 76, the Commissioner changed the rule in I.T. 3740, but stated, pursuant to his discretionary authority under Section 7805(b) of the Code, that he would apply Revenue Ruling 68-643 "without retroactive effect" to prepayments of interest for not more than five years by cash basis taxpayers made prior

to November 26, 1968, or pursuant to a legal obligation incurred prior to that date.

The Holgersons were taxpayers who relied on I.T. 3740 and the statement in Revenue Ruling 68-643 that it would be applied without retroactive effect on contracts binding on November 25, 1968. Pursuant to such contracts, they prepaid interest (in material part after November 25, 1968) in connection with several purchases of real estate, all entered into on or before November 25, 1968. The Holgersons deducted such interest payments on their federal income tax returns for 1967, 1968 and 1969. As cash basis taxpayers, if they had not deducted the amounts when paid, they would have lost the deductions forever. Treas. Reg. § 1.461-1(a)(3); Carlisle v. Commissioner, 37 T.C. 424, 428 (1961); Hickman v.

Commissioner, 32 CCH T.C.M. 1095 (1973). The Commissioner disallowed the deductions and required that the interest payments be prorated, resulting in tax deficiencies of $217,100.93 for 1967, $318,760.70 for 1968 and $96,046.17 for 1969.

The Holgersons petitioned for review of these deficiencies by the United States Tax Court pursuant to Code Section 7442. The facts of the transactions are set forth in full in the Tax Court opinion. In brief, the Holgersons invested in several pieces of real estate with the intention of acquiring some income-producing property for Mr. Holgerson's retirement years. Five of the Holgersons' transactions were at issue before the Tax Court. With respect to three of the transactions, the Tax Court held that I.T. 3740 did not apply, or

should be interpreted narrowly. With respect to the remaining two transactions, the Tax Court treated part of the interest paid as non-deductible, but permitted the remaining interest to be deducted in the year of payment, pursuant to I.T. 3740 and Revenue Ruling 68-643. The three transactions in which the Tax Court refused to apply I.T. 3740, and one of the remaining transactions, were presented for review to the Ninth Circuit, which upheld the Tax Court's determination. The three transactions in which the Tax Court refused to apply I.T. 3740 to permit the Holgersons to deduct the interest payments are outlined below. In none of these transactions did the notes given by the Holgersons provide for a rebate of interest or principal.

On December 13, 1967, approximately a year before the issuance of Revenue Ruling 68-643, the Holgersons agreed with Walnut Growers, Inc. ("Walgro"), and the Walgro shareholders to purchase approximately 631 acres of farm land together with trees and improvements. The agreement provided for a total purchase price of $1,955,250 to be paid in cash, through the assumption by the Holgersons of first and second mortgages on the property, and $973,174.50 through a promissory note from the Holgersons. The agreement required the Holgersons to pay to Walgro on the date of sale $250,000 as a prepayment of approximately three and two-thirds years interest on the Holgersons' note, to be applied to years before February 1, 1976, as designated by Walgro.

The Holgersons paid the $250,000 to Walgro on or about December 13, 1967. The Holgersons paid interest on their purchase-money note in the years 1968 through 1972, and Walgro applied the $250,000 interest prepayment to the interest requirements of the note to the years 1973 through 1976.

The Tax Court required the interest paid by the Holgersons to be deducted at the rate of 7% of the principal amount of the note per year for the years 1967 through 1969.

On November 25, 1968, pursuant to negotiations that had begun several months earlier, the Holgersons entered into a contract with Aerojet-General Corporation ("Aerojet") to purchase for $2,650,000 an aging office and research complex formerly used by Aerojet. Under the agreement between

the Holgersons and Aerojet, the purchase price was payable by means of a 10-year promissory note bearing interest initially at 7%, increasing to 8% after 1974. Three years of interest on the note was to be paid on or before May 1, 1969, with $400,000 of this amount payable at closing and the balance payable on or before May 1, 1969. At the closing on December 18, 1968, the Holgersons paid $300,000 as prepaid interest and on May 1, 1969, they paid an additional $145,200 as prepaid interest. The remainder was paid by the Holgersons' partners in the purchase. Principal on the promissory note was payable in part based on fixed amounts and in part based on the excess of actual rents for the property over the rents of a base period. The actual principal paid

was the fixed installments. The principal payments were not so large as to cause the interest prepaid to satisfy interest due on the note for more than five years.

The Tax Court required the prepaid interest paid by the Holgersons in this transaction to be deducted on an accrual basis in the years in which the interest was payable under the note to Aerojet.

On December 21, 1967, the Holgersons agreed to purchase Pine Terrace Apartments from the Duffel-Smoot Companies for $1,000,000. On December 29, 1967, the transaction was closed and the Holgersons became owners of the property. At the closing, the Holgersons paid the purchase price by assuming the existing first deed of trust in the amount of $655,240.97,

giving a promissory note secured by a second deed of trust in the amount of $274,759.03 and paying $70,000 in cash. The Holgersons' note provided for interest from December 31, 1967, at 8% per year. Principal and interest was payable in $3,000 installments on the first day of each month from October 31, 1974 until December 31, 1977, on which date the unpaid principal and interest would become due and payable, except that if the note were paid on or before October 31, 1974, it could be discharged through payment of $199,759.03. The note was discharged in 1974 at this amount. At the close of escrow the Holgersons paid to Duffel-Smoot $150,201.52 as prepaid interest on the note for the period up to October 31, 1974.

The Tax Court held that only $109,201.60 of the $150,201.52 prepaid as interest on the note was deductible as interest, and required this $109,201.60 to be deducted on a prorated basis over the years 1967 through 1974.

In its decision, the Tax Court stated a number of reasons for narrowly applying I.T. 3740 and the non-retroactivity provisions of Revenue Ruling 68-643: In the Walgro transaction, Walgro retained the right to specify when the prepaid interest would be applied; in the City Annex transaction, the prepaid interest could theoretically have been applied for a period in excess of five years because the schedule of principal payments was in part contingent, although no finding was made as to the actual possibility (which was

so remote as to be negligible) of this occurring; in the Pine Terrace transaction, the prepayment of interest was for a period in excess of the five year period set forth in I.T. 3740. The petitioners urged in brief and argument before the Tax Court both the applicability and the binding effect of the Commissioner's rulings.

On December 8, 1978, the Holgersons filed a Notice of Appeal in the Ninth Circuit Court of Appeals, pursuant to Code Section 7482. In the Ninth Circuit, the Internal Revenue Service argued that the rulings were irrelevant, relying on the Ninth Circuit's prior decisions in Sandor v. Commissioner, 62 T.C. 469 (1974), aff'd per curiam, 536 F.2d 874 (9th Cir. 1976), and Cole v. Commissioner, 64 T.C. 1091 (1975), aff'd 586 F.2d 747

(9th Cir. 1978), cert. denied, 441 U.S. 924 (1979), in which the Ninth Circuit held that the only issue was whether the Commissioner had abused his discretion in disallowing prepaid interest deductions. On January 30, 1981, the Ninth Circuit rendered its decision, holding, "We agree with the Tax Court that the Commissioner acted reasonably and within the scope of his discretion. . . ." (App. B, infra.) The Holgersons then petitioned the Ninth Circuit for a rehearing on the basis that its decision improperly refused to permit them to rely on a method of accounting approved by the Commissioner in a public ruling, in conflict with the decisions of other Circuits and other Ninth Circuit decisions. On May 21, 1981, the Ninth Circuit denied the petition while

simultaneousely changing its original decision to eliminate any reference to I.T. 3740, Revenue Ruling 68-643 and the discretion of the Commissioner.

REASONS FOR GRANTING THE WRIT

This petition should be granted for the following reasons:

1. The decision of the Court of Appeals is in conflict with decisions of this Court, decisions of other Courts of Appeals and the Court of Claims, and its own earlier decisions. The resulting confusion urgently requires the authoritative intervention of this Court.

This Court has recognized in other contexts that the public has been encouraged to rely on the published pronouncements of administrative agencies (Ford Motor Credit

Co. v. Milhollin, 444 U.S. 555 (1980)), and that because administrative agencies have the power to make rules that affect substantive individual rights, the agencies have the obligation to follow their own rules published for the guidance of the public (E.g., United States ex rel. Accardi v. Shaughnessy, 347 U.S. 260 (1954); Morton v. Ruiz, 415 U.S. 199 (1974); United States v. Caceres, 440 U.S. 741 (1979)). The Internal Revenue Service should not be governed by a different rule. Other courts have recognized that the Internal Revenue Service is bound by its published rulings when they represent an exercise of discretion conferred by statute (State Bank of Albany v. United States, 530 F.2d 1379 (Ct. Cl. 1976); North Carolina Nat'l Bank v. United States, 345 F.2d 544 (Ct. Cl. 1965)), and other Circuit Courts of

Appeals have applied the rulings here involved according to their terms (Burck v. Commissioner, 533 F.2d 768 (2d Cir. 1976); Anderson v. Commissioner, 568 F.2d 386 (5th Cir. 1978); Resnik v. Commissioner, 555 F.2d 634 (7th Cir. 1977). Yet the Ninth Circuit's opinion in this case avoided the issue of whether the rulings involved were binding on the Commissioner. The Ninth Circuit's decision furthermore is contrary to its own earlier decisions on the Commissioner's authority to prescribe methods of accounting and the effect of his published rulings. See Sandor v. Commissioner, supra; Cole v. Commissioner, supra; Gino v. Commissioner, 538 F.2d 833 (9th Cir.), cert. denied 429 U.S. 979 (1976); Estate of Lang v. Commissioner, 613 F.2d 770 (9th Cir. 1980). The Holgerson case offered the Ninth Circuit the

opportunity to resolve the many conflicts concerning the effect of the Commissioner's exercise of discretion through a published ruling prescribing a method of accounting. Through its two decisions in this case, however, the Ninth Circuit has created more confusion and uncertainty.

2. The proper disposition of this case involves an important question of law which should be settled by this Court. The case involves a question of fundamental fairness to all taxpayers and is important to the administration of the federal tax laws generally. The Ninth Circuit allowed the Commissioner, after he had, pursuant to Section 446(b) of the Code, exercised in published rulings his discretion to approve the methods of accounting here involved, retroactively to

disregard such approval for a single taxpayer. This case presents the Court with the opportunity to determine whether the Commissioner can disregard such approval of a method of accounting with respect to a particular taxpayer. Contrary to the general rule that a ruling is merely a statement of the Commissioner's opinion, a published ruling in which the Commissioner exercises discretion conferred on him by statute has been recognized as binding on the Commissioner and the taxpayer alike. E.g. State Bank of Albany v. United States, supra; North Carolina Nat'l Bank v. United States, supra. Revenue Ruling 68-634 and I.T 3740 here involved were issued by the Commissioner pursuant to his discretionary authority under Section 446(b) and should be binding upon him. Further, the respondent

exercised his discretionary authority under Section 7805(b) of the Code expressly to make nonretroactive the applicability of Revenue Ruling 68-643 and should be bound by such exercise of his discretion.

3. Published Revenue Rulings function as a guide to taxpayers in planning their financial transactions. They therefore should be interpreted broadly rather than narrowly and in the taxpayers' favor when there is any ambiguity. Allowing the Commissioner to disregard his official pronouncements through narrow interpretation creates needless uncertainty in the administration of the tax laws and skepticism on the part of the taxpayers as to their fair and even application. A reasonable interpretation of I.T. 3740 and Revenue Ruling 68-643 would have allowed the deductions at issue.

I.

The Petition Should Be Granted Because the Decision of the Court of Appeals is in Conflict with Decisions of this Court, Decisions of Other Courts of Appeals and the Court of Claims, and Its Own Earlier Decisions.

The Ninth Circuit's two decisions in this case illustrate the confusion and uncertainty surrounding the issue of the authority of the Commissioner's official pronouncements. By analyzing the effect of each decision and comparing it to decisions of this Court and other decisions of the Ninth Circuit, other sister Circuits and the Tax Court, the Court will become aware of how great is the confusion with respect to such administrative pronouncements.

Before the Ninth Circuit, the Commissioner argued that:

> [T]he Commissioner's action under Section 446(b) to clearly reflect income is sustainable, irrespective of whether Rev. Rul. 68-643 was properly applied retroactively. Appellee's Brief at 32.

This argument was convincing to the Ninth Circuit, which concluded its first opinion: "We agree with the Tax Court that the Commissioner acted reasonably and within the scope of his discretion, and for the reasons set forth in the Tax Court's Opinion, we affirm." (App. C., infra.) In so doing, the Ninth Circuit followed some of its earlier decisions where the Circuit, at the invitation of the Internal Revenue Service, had held that the Commissioner of Internal Revenue could arbitrarily disregard his published rulings based on his general discretionary power over methods of accounting. Sandor v. Commissioner, supra; Cole v. Commissioner, supra.

This view of the effect of Revenue Rulings is similar to but more radical than that of the United States Tax Court. The Tax Court did not attempt to judge the Commissioner's actions against the inchoate standards of "reasonableness" and "discretion" attributed to it by the Ninth Circuit, but purported to apply the standards of Revenue Ruling 68-643, although it acknowledged that its reading was a narrow interpretation of the ruling's language. 69 T.C. at 458. In so doing, the Tax Court explicitly avoided stating that these published administrative pronouncements were binding on the Commissioner:

> We have consistently declined to decide whether everything said in such ruling is valid or whether such ruling may be validly applied in all cases to which it purports to apply. 69 T.C. at 456 n. 8.

In other cases, the Tax Court has dismissed Revenue Rulings as "simply the contention of one of the parties." Estate of Lang v. Commissioner, supra. See also Stubbs, Overbeck & Associates, Inc. v. United States, 45 F.2d 1142 (5th Cir. 1971).

The Ninth Circuit's first opinion also was inconsistent with the decisions of other Circuits, which have generally applied Revenue Ruling 68-643 pursuant to its terms rather than relying on unbounded notions of reasonableness and abuse of discretion. For example, the leading case of Burck v. Commissioner, supra, reviewed the facts with an eye toward "whether the Commissioner has abused his discretion in his determination, pursuant to Rev. Ruling 68-643 and Reg. 1.446-1(a), that the appellant's claimed deduction for prepaid interest expense

resulted in a failure clearly to state his income." Id. at 774 (emphasis added). See also Anderson v. Commissioner, supra; Resnik v. Commissioner, supra.

All such decisions are consistent with decisions of this Court and lower courts regarding the obligation of an administrative agency to follow its own rules published for the guidance of the public. See, e.g., United States ex rel. Accardi v. Shaughnessy, supra; United States v. Caceres, supra; State Bank of Albany v. United States, supra.

Finally, the Ninth Circuit's first decision conflicted with its own decision in Gino v. Commissioner, supra, in which the court stated, in a situation where the Internal Revenue Service had published a ruling unfavorable to the taxpayer involved:

> Where a revenue ruling has been published by the Internal Revenue Service for the purpose of solving this particular problem, such as the ruling relied upon here by appellant, considerations of fair and effective administration of the tax law persuade us to the Commissioner's view, particularly in a close case. Gino v. Commissioner, supra at 835.

In the Gino case, the Commissioner argued, both before the Ninth Circuit and in opposition to the petition for certiorari in this Court, that revenue rulings were part of the "rules and regulations" of the Internal Revenue Service, entitled to the deference provided by United States v. Correll, 389 U.S. 299, 306 (1967), a view of rulings entirely incompatible with that put forth by the Commissioner in Holgerson and the other prepaid interest cases in the Ninth Circuit.

Faced with these arguments, the Ninth Circuit did not clarify its own view of the authority of the rulings but simply deleted the language on the discretion of the Commissioner and any reference to I.T. 3740 and Revenue Ruling 68-643. Obviously, it recognized the error of its decision and attempted to cure its infirmities by purging the record of the basis for its opinion. But the record is not so easily cured. The Commissioner's abuse of discretion cannot be covered over by a parallel error by the Appellate Court.

The issue presented still remains. The question here is too significant to taxpayers, and the conflicts among the various courts which have considered this issue too glaring, to permit this matter to pass without considered decision. This

Court, while it has classified the status of Treasury Regulations in several recent cases (Rowan Companies, Inc. v. United States, 49 U.S.L.W. 4646 (June 8, 1981); Commissioner v. Portland Cement Co. of Utah, 49 U.S.L.W. 4189 (March 3, 1981); Alessi v. Raybestos-Manhattan, Inc., 49 U.S.L.W. 4503 (May 18, 1981)), has yet to set forth a consistent view of the authority of rulings, particularly in the context of an attempt by the Commissioner to avoid application of a ruling of general effect to a particular taxpayer.

II.

The Petition Should Be Granted Because the Proper Disposition of This Case Involves an Important Question of Law Which Should be Settled by This Court.

This case raises a critical question in the administration of the tax laws. Section 446(b) gives the Commissioner

the power to require a taxpayer to use a method of accounting that clearly reflects income. It does not, however, give the Commissioner the unbridled discretion arbitrarily to fix a taxpayer's income in any amount or to compute income unguided by any standards, but only to require that a proper method be used. The discretion given to the Commissioner is not uncontrolled or unchanneled; rather it permits the Commissioner only to set and approve methods of accounting. Once he has approved an accounting method, his discretion is exhausted. See Auburn Packing Co. v. Commissioner, 60 T.C. 794 (1973).

The Commissioner's power to approve or disapprove of methods of accounting need not be exercised only through Treasury Regulations, but may also

be exercised through other official pronouncements. A ruling can be the "Commissioner's exercise of discretion" authorized by the statute and, in the context of an express delegation of discretion to the Commissioner, a ruling is "a rule of general application binding on the Commissioner and the taxpayer." State Bank of Albany v. United States, supra at 1381. This is consistent with the general principle of administrative law that agencies are bound by the rules that they issue for the guidance of the public.

In this and other prepaid interest cases, the Commissioner has consistently argued that I.T. 3740 is merely a statement of administrative position. He has urged that he retains the discretion to alter a taxpayer's method of accounting

pursuant to an inchoate statutory discretion, notwithstanding the taxpayer's compliance with the specific methods of accounting publicly required by the Commissioner. But I.T. 3740, and other rulings regarding methods of accounting, do not purport to be so limited. They are official approvals of methods of accounting. I.T. 3740, for example, both permitted and required interest paid in advance for a period of five years to be deducted in the year in which paid. If the deduction were not taken in the year of payment, then it could not be taken at all. As stated in the ruling, "A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or

other charges, he can not deduct them from the income of the next or any succeeding year."

Nor did Revenue Ruling 68-643 characterize I.T. 3740 as a mere statement of position as to which deductions would or would not be challenged. The Revenue Ruling recognized that I.T. 3740 prescribed a method of accounting, binding on both taxpayers and the Commissioner and that what was involved in the new formulation was a change in such method of accounting and not the correction of "an error of law," as now claimed by the

Commissioner.*/ Cf. Auburn Packing Co. v. Commissioner, supra.

The Court of Claims has specifically recognized that where the Commissioner

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*/ The Commissioner's exercise of his discretionary power to make Revenue Ruling 68-643 nonretroactive had the distinct purposes not only to protect the legitimate reliance interests of taxpayers but to enable and require taxpayers to change from one method of accounting for prepaid interest to another without risk of double deduction, pursuant to Treasury Regulations § 1.446-1(e)(3)(ii), and without permitting taxpayers to take advantage of Section 481 of the Code, which permits taxpayers to compute the taxes payable as a result of a required change in method of accounting as if the increased income was spread over three years. If the Ruling applied retroactively, and purported to correct a mere error, taxpayers who had previously deducted interest when prepaid could have again deducted that interest in the years in which it accrued, subject only to the possible application of Section 1311 of the Code.

exercises discretion conferred upon him by statute through a published ruling, the ruling is binding on the Commissioner and the taxpayer alike:

> In 1947, the IRS published Mim. 6209. It is well established that Mim. 6209 is the Commissioner's exercise of discretion authorized by Sec. 166(c). While it does not have the force and effect of law or regulation, it is a rule of general application binding on the Commissioner and the taxpayer. North Carolina Nat'l Bank v. United States, 345 F.2d 544, 107 Ct. Cl. 765 (1965). As decided in that case, the promulgation of Mim. 6209 and a taxpayer's timely election to follow it brings into effect something analogous to a binding contract. State Bank of Albany v. United States, supra at 1381.

Under general principles of administrative law, the Commissioner may not exercise his discretion one way for the mass of cases and yet arbitrarily deny the benefit of this exercise to particular

individuals otherwise qualifying therefor. This Court should not countenance a procedure which makes the Commissioner's decisions as to methods of accounting retroactive as to some, but not as to others, or which permits the Commissioner to take back through litigation in individual cases what is permitted in discretionary, published rulings of general application. If a tax system based on self-assessment is to be successful, it must be administered through general rules generally applicable, rather than through unbridled discretion arbitrarily applied. This case presents an appropriate vehicle for reaffirmation of that principle.

III.

The Petition Should Be Granted Because the Decisions of the Tax Court, and of the Ninth Circuit Through Its Affirmance, Were Wrong in Their Manner of Application of the Rulings Here Involved.

Not only should the Commissioner's published pronouncements be binding, but the pronouncements should not be read "narrowly" against taxpayers who rely on such pronouncements, reading their words in their natural and intended sense. The Commissioner, not taxpayers, drafts and issues Revenue Rulings. By interpreting the rulings narrowly, the Tax Court allowed the Commissioner to evade any responsibility for consistency in the interpretation of these published pronouncements.

The basic question is one of fairness -- to the Holgersons in this case

and to all United States taxpayers in future cases. I.T. 3740 was relied on by the Holgersons and had been relied on by other taxpayers for many years. Its language was clear and simple: Prepayments of interest for periods not in excess of five years were deductible when paid.

The courts have consistently recognized that the Commissioner's official pronouncements should be read in plain English. As the Ninth Circuit said in E.E. Black, Ltd. v. Alsup, 211 F.2d 879 (9th Cir. 1954), "In short, we are of opinion that the Regulation should be taken as meaning what it plainly says, ..." Id. at 880. See also Thompson-King-Tate, Inc. v. United States, 296 F.2d 290 (6th Cir. 1961); Rice, Barton & Fales, Inc. v. Commissioner, 41 F.2d 339 (1st

Cir. 1930). The same rule should apply to the interpretation of I.T. 3740 and Revenue Ruling 68-643. Are their words to be given their customary and normal meanings, or are they to be read as narrowly and hostilely as possible? If I.T. 3740 and Revenue Ruling 68-643 are interpreted in an ordinary, common sense manner, the Holgersons' prepayments of interest are deductible in accordance with their terms.

Allowing the Commissioner to evade his published pronouncements places the taxpayer in an unwarranted predicament. As I.T. 3740 specifically stated, if a cash basis taxpayer did not deduct the interest when paid, he lost the deduction forever. Yet years later, after the taxpayers' business transactions are completed and the taxpayers have no opportunity

or leverage to renegotiate the transactions to preserve their financial advantages, the Commissioner was allowed to ignore his pronouncements which stated in sum that (i) "where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid" (I.T. 3740); (ii) "[a] taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from income of the next or any succeeding year" (I.T. 3740); and (iii) "Revenue Ruling [68-643] will be applied without retroactive effect to

interest prepayments for periods not in excess of five years made prior to November 26, 1968, by taxpayers employing the cash receipts and disbursements method of accounting . . . [and] will be applied without retroactive effect to an interest prepayment for a period not in excess of five years made on or after November 26, 1968, by a taxpayer employing the cash receipts and disbursements method of accounting, pursuant to a legal obligation incurred prior to such date to make such prepayment" (Rev. Rul. 68-643).

This Court has recognized that the public should be allowed to rely on the official pronouncements of an administrative agency because of its need for guidance as the laws become increasingly complex. Ford Motor Credit Co. v.

Milhollin, supra. And this Court has emphasized the need for consistency in the application and interpretation of published administrative positions. Morton v. Ruiz, supra; General Electric Co. v. Gilbert, 429 U.S. 125 (1976). The Commissioner of Internal Revenue is not entitled to an exemption from these general rules of administrative law.

Allowing the Commissioner unbridled discretion to enforce or ignore his published pronouncements at will makes financial planning akin to navigating the seas between Scylla and Charybdis and serves to cast in doubt the fair, consistent and certain application of the federal tax laws. We cannot say more of the taxpayers' predicament than Mr. Justice Jackson's penetrating analysis in

Helvering v. Griffiths, 318 U.S. 371 (1943), in which he reminded this Court of the evils of retroactivity in taxation: "If he consulted the decisions" of the courts, he learned that no such tax could be imposed." If he read the relevant statutes "in connection with existing decisions," they also "assured him there was no intent to tax." If he carefully "followed the Congressional proceedings" or acquiescence in established rulings, "his understanding of nontaxability would be confirmed." Finally, "if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government." Id. at 402.

In misapplying Section 446(b), the Court of Appeals has raised fundamental issues concerning the scope of that significant statute. Only this Court can set those issues at rest.

CONCLUSION

For the foregoing reasons, this petition should be granted.

Dated: August 19, 1981.

Respectfully submitted,

JULIAN N. STERN
Counsel for Petitioners

(Appendices in Separate Volume)

Appendix

Office-Supreme Court, U.S.
FILED
AUG 19 1981
ALEXANDER L. STEVAS,
CLERK

81-348

No.

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1981

HARRY T. and MARY HOLGERSON, JR.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Appendix A

United States Court of Appeals,
Ninth Circuit.

Harry T. Holgerson, Jr. and Mary Holgerson,
Appellants,

vs.

Commissioner of Internal Revenue,
Appellee.

No. 79-7038.

Argued and Submitted Nov. 17, 1980.

Decided Jan. 30, 1981.

As Amended on Denial of Rehearing
May 21, 1981.

Appeal from the Decision of the United States Tax Court.

Before DUNIWAY and KENNEDY, Circuit Judges, and CURTIS,* District Judge.

CURTIS, District Judge:

This is an appeal from a decision of the Tax Court upholding the Commissioner's disallowance of the taxpayers' deduction of "prepaid interest" during the taxable years 1967, 1968, and 1969.

In 1967 and 1968, Mr. Holgerson invested in several pieces of real estate with the intention of acquiring some

*Honorable Jesse W. Curtis, United States District Judge, Central District of California, sitting by designation.

good income producing property for his retirement years. In each of these transactions, substantial amounts of money were paid as "prepaid interest." In joint returns filed during these years, the Holgersons sought to take deductions for the "prepaid interest" payments in accordance with I.T. 3740, 1945 C.B. 109, which they believed applicable. The Commissioner refused to permit the deductions, and required that such interest paid in advance be prorated, which resulted in tax deficiencies of $217,100.93 for 1967, $318,760.70 for 1968, $96,046.17 for 1969.

The Commissioner's disallowance was upheld by the Tax Court, and the taxpayers now appeal. *See Roemer, et al.*, 69 T.C. 440 (1978).

The Holgersons have attacked the decision of the tax court upon numerous grounds, each of which has been carefully analyzed and ruled upon by the tax court in a twenty-seven page Opinion. We think that Opinion clearly and correctly answers all of appellants' contentions and we can do no better than to adopt it as our own. We affirm.

Appendix B

United States Court of Appeals
For the Ninth Circuit

CA No. 79-7038
(No. 3915-74)

Harry T. Holgerson, Jr. and Mary Holgerson
Appellants,

vs.

Commissioner of Internal Revenue,
Appellee.

On Appeal from the Decision of the
United States Tax Court.

Argued and submitted November 17, 1980.

Decided January 30, 1981.

Before: DUNIWAY and KENNEDY, Circuit Judges, and CURTIS,* District Judge

ORDER

Good cause appearing therefor, the Opinion in the above entitled case filed herein on January 30, 1981 is modified as follows:

The two concluding paragraphs on page 2, commencing on line 4 thereof are stricken and in place thereof the following shall be inserted:

*Honorable Jesse W. Curtis, United States District Judge, Central District of California, sitting by designation.

The Holgersons have attacked the decision of the tax court upon numerous grounds, each of which has been carefully analyzed and ruled upon by the tax court in a twenty-seven page Opinion. We think that Opinion clearly and correctly answers all of appellants' contentions and we can do no better than to adopt it as our own. We affirm.

The Opinion having been modified, the Petition for a Rehearing is hereby denied.

Appendix C

United States Court of Appeals,
Ninth Circuit.

Harry T. Holgerson, Jr. and Mary Holgerson,
Appellants,
vs.
Commissioner of Internal Revenue,
Appellee.

No. 79-7038.

Argued and Submitted Nov. 17, 1980.

Decided Jan. 30, 1981.

Appeal from the Decision of
the United States Tax Court.

Before DUNIWAY and KENNEDY, Circuit Judges, and CURTIS,* District Judge.

CURTIS, District Judge:

This is an appeal from a decision of the Tax Court upholding the Commissioner's disallowance of the taxpayers' deduction of "prepaid interest" during the taxable years 1967, 1968, and 1969.

In 1967 and 1968, Mr. Holgerson invested in several pieces of real estate with the intention of acquiring some good income producing property for his retirement years. In each of these transactions, substantial amounts of money were paid as "prepaid interest." In joint returns filed during these years, the Holgersons sought to take deductions

*Honorable Jesse W. Curtis, United States District Judge, Central District of California, sitting by designation.

for the "prepaid interest" payments in accordance with I.T. 3740, 1945 C.B. 109, which they believed applicable. The Commissioner refused to permit the deductions, and required that such interest paid in advance be prorated, which resulted in tax deficiencies of $217,100.93 for 1967, $318,760.70 for 1968, $96,046.17 for 1969.

The Commissioner's disallowance was upheld by the Tax Court, and the taxpayers now appeal. *See Roemer, et al.*, 69 T.C. 440 (1978).

The Holgersons argue that the Commissioner abused his discretion in disallowing deductions of "prepaid interest," since these transactions involving such payments were entered into in reliance upon I.T. 3740, which permitted them to deduct prepaid interest beyond twelve months, but less than five years. The Commissioner, on the other hand, supports his disallowance in reliance upon Rev. Rul. 68-643, 1968-2 C.B. 76, which makes prepayment of interest for a period in excess of twelve months by a cash basis taxpayer a "material distortion of income," which he has authority to disallow.

Judge Forrester of the Tax Court filed a twenty seven page Opinion in which he fully analyzed and discussed each of the contentions which the appellants make here. We agree with the Tax Court in its holding that the Commissioner acted reasonably and within the scope of his discretion, and for the reasons set forth in the Tax Court's Opinion, we affirm.

Appendix D

United States Tax Court

Paul F. Roemer, Jr., and Marcia E. Roemer, et al.,[1]
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

Docket Nos. 3837-74, 3838-74, 3915-74.

Filed December 12, 1977.

In five separate transactions petitioners paid certain amounts which were designated as prepaid interest. *Held,* Rev. Rul. 68-643, 1968-2 C.B. 76, by its terms, applies retroactively to an interest prepayment sufficient to pay 3⅔ years' interest where such amount may be, and is applied, at the sole discretion of the lender, to satisfy interest obligations arising during a period in excess of 5 years from the prepayment date. *Held, further,* Rev. Rul. 68-643 applies retroactively to the entire amount of an interest prepayment for an indefinite period where there is at least a probability that the period may extend beyond 5 years. *Held, further:* The amount which petitioners were obligated to pay on a purchase money note was the stated principal amount less the discount for prepayment, and part of the amount designated as prepaid interest was a payment on the purchase price. Petitioners' basis in the purchased property should be adjusted accordingly. *Held,*

[1]Cases of the following petitioners are consolidated herewith: Robert S. Brickell and Roberta A. Brickell, docket No. 3838-74; and Harry T. Holgerson, Jr. and Mary E. Holgerson, docket No. 3915-74.

further, an amount designated as prepaid interest was not "paid," for sec. 163(a) purposes, to the extent that it was withheld from the proceeds of a $160,000 note. *Held, further:* A debt is not a sham where, aside from tax benefits, the debtor realistically anticipates to profit from the transaction. There is no requirement that deductible interest serve a business purpose. *Held, further:* Interest was prepaid pursuant to a legal obligation incurred prior to November 26, 1968, where the sellers were bound prior to such date to sell a leasehold interest and petitioners were bound to buy it according to terms requiring the prepayment. Rev. Rul. 68-643, by its terms, does not apply to such prepayment.

Paul F. Roemer, Jr., pro se.

Robert S. Brickell, pro se.

Julian N. Stern and *Robert C. Alexander,* for the petitioners in docket No. 3915-74.

Lawrence G. Becker, for the respondent.

Forrester, *Judge*: In these consolidated cases, respondent has determined deficiencies in petitioners' Federal income taxes as follows:

Petitioners	Taxable Year	Amount
Paul F. Roemer, Jr., and Marcia E. Roemer, docket No. 3837-74	1968	$ 20,817.55
	1969	4,837.21
Robert S. Brickell and Roberta A. Brickell, docket No. 3838-74	1968	23,727.94
	1969	90.67
Harry T. Holgerson, Jr., and Mary E. Holgerson, docket No. 3915-74	1964	1,883.05
	1965	133,754.58
	1966	221,513.25
	1967	385,666.48
	1968	428,111.80
	1969	207,583.51

Concessions having been made, there are two issues remaining for our decision: (1) Whether certain amounts designated as interest are deductible by petitioners, pursuant to section 163(a),[2] for the years in question, and (2) whether the petitioners' deduction of prepaid interest in the year of payment distorts their income.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Petitioners reside in California at the time they filed their petitions herein. They filed Federal income tax returns for the years in issue with the offices of the Internal Revenue Service at San Francisco, Calif. (for some of the years at issue in docket No. 3915-74), and Ogden, Utah.

Petitioner Harry T. Holgerson, Jr. (Holgerson), was in the business of buying and selling used airplane parts, and there was a substantial increase in his income from that business for the years 1967, 1968, and 1969. Dale Kimbell (Kimbell), a certified public accountant, kept Holgerson's books during the years in issue and advised him of his potential increased income tax liabilities arising from his increased income during those years. Kimbell suggested that one of the means available to Holgerson for reducing his potential tax liability would be prepayment of interest on investments which he made. The ability to characterize a portion of the funds paid by him as prepaid interest was a factor which Holgerson considered favorably when choos-

---

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954.

ing investments, but his prime consideration was that the investment be a good one which would provide income for him during his retirement years.

1. *Walgro*

On December 13, 1967, Holgerson and his wife, Mary (the Holgersons), agreed with Walnut Growers, Inc. (Walgro), Walgro shareholders, and their wives to purchase approximately 631 acres of farmland together with trees and improvements (Walgro property). Such agreement read in part as follows:

D. Sale: Walgro to Holgersons

* * * * *

2. *Agreement.*

Now, Therefore, Holgersons hereby agree to buy from Walgro, and Walgro hereby agrees to sell to Holgersons, the Property * * * pursuant to the terms and conditions of this General Agreement.

3. *Price.*

The total purchase price for the Property shall be $1,955,250.00.

4. *Terms of Payment.*

Holgersons shall pay this purchase price as follows:

a. *Cash.* A down payment by Holgersons into the escrow of $25,000 in cash.

b. *Assumption of Indebtedness.*

(1) Assumption by Holgersons of all of the indebtedness set out * * * above, a total of $957,075.50 principal, plus interest, it being understood that proration of interest on this indebtedness shall be made between

Walgro and Holgersons as of the closing date of this sale.

• • • • •

c. *Promissory Note.* A promissory note from Holgersons to Walgro for the remaining $937,174.50.

• • •

• • • • •

5. *Prepayment of Interest.*

Concurrently with this sale, the Holgersons shall pay to Walgro, and Walgro shall accept, the sum of $250,000.00, as prepayment of interest on the note referred to in D4c, above, to be applied to such installments of interest to fall due under that note on or before February 1, 1976, as Walgro may at its option designate.

On or about December 13, 1967, Holgerson made the $25,000 and $250,000 payments and assumed the $957,075.50 indebtedness. On December 13, 1967, the Holgersons executed the $973,174.50 promissory note providing for interest on the unpaid principal balance at a rate of 7 percent from December 13, 1967, until December 13, 1977, and thereafter at a rate of 4½ percent until final payment of the principal. Such interest was payable in installments beginning February 1, 1968, with subsequent interest payments payable annually thereafter on the first day of February, and principal payments were to be made annually beginning on February 1, 1978, in the amount of $48,658.72.

In addition to the prepaid interest, Holgerson made further interest and principal payments on the December 13, 1967, note as follows:

Year	Interest	Principal
1968	$9,257.50	0
1969	68,122.22	0
1970	68,122.22	0
1971	68,122.22	0
1972	68,122.22	0
1973	22,488.88	0
1974	0	0
1975	0	0
1976	0	0

No interest payments were made for 1974-76, and a reduced payment was made in 1973, because Walgro applied the $250,000 interest prepayment to the interest requirements of the note for those years. The Holgersons leased the Walgro property back to Walgro as part of the same transaction in which they purchased it. Such lease provided in part as follows:

> 5. *Schedule of Rentals.* Lessee shall pay to Lessor, as rental for the Property, the following sums on the dates indicated:
>
> | Date | Amount of rental payment due |
> |---|---|
> | Jan. 31, 1968 | $15,000 |
> | Oct. 30, 1968 | 0 |
> | Jan. 31, 1969 | 45,000 |
> | Oct. 30, 1969 | 0 |
> | Jan. 31, 1970 [and each Jan. 31 of succeeding years up to and including 1977] | 55,000 |
> | Oct. 30, 1970 [and each Oct. 30 of succeeding years up to and including 1977] | 77,500 |
>
> • • • • •
>
> 6. *Duties of Lessee.* In addition to the duty to pay the rentals set out in 5, above, Lessee shall have the following duties toward Lessor:
>
> (a) *Farming.* To continue the farming operations on the Property, and to conduct these operations in a

good and farmer-like manner. Lessee shall not, however, be liable for the consequences of any force majeure, which shall be defined as any cause not within Lessee's reasonable control, such as an act of God (e.g., lightning; fire; extraordinary drought, flood, or freezing; earthquake; epidemic, etc.); a riot or labor disturbance; a governmental act or decree; etc.

• • • • •

(d) *Other expenses of farming operations.* To pay all expenses arising out of the farming operations on the Property, and to indemnify Lessor against any and all expenses Lessor may reasonably incur as a result of these operations.

Approximately 250 acres of the Walgro property had been planted with new walnut trees shortly prior to the Holgersons' purchase of the property, and all of the orchards were in an early stage of development. The Holgersons reported losses from the Walgro property as follows: $252,349 in 1967, $166,332 in 1968, and $239,713 in 1969.

The $250,000 paid by the Holgersons under the December 13, 1967, agreement and designated as prepaid interest was deducted as interest by the Holgersons on their 1967 return. In his statutory notice, respondent determined that the amount paid the Holgersons as prepaid interest was deductible beginning December 13, 1967, at a rate of 5.7732 percent per year of the outstanding principal.

2. *City Annex*

On November 23, 1968, the Holgersons executed and mailed to Aerojet-General Corp. (Aerojet) an offer to

purchase from Aerojet the property located in Sacramento, Calif., known as City Annex. The City Annex property consisted of approximately 31.41 acres of land on which there was a manufacturing plant and a warehouse.

Such offer read in part as follows:

> 1. *Purchase price and payment therefor.* The total purchase price shall be the sum of $2,650,000. The Buyer shall pay the purchase price at the closing of the escrow referred to herein by executing and delivering to the Seller a promissory note in the usual form in the principal amount of $2,650,000, secured by a deed of trust in the usual form on the property. Such promissory note shall bear interest as set forth herein and provide for payments of principal and interest as follows:
>
> (a) At the closing, and on May 1, 1969, Buyer shall pay an amount equal to three years in prepaid interest (computed at 7% per annum) in this manner:
>
> (i) At closing $400,000. The Buyer shall deposit $50,000 of such $400,000 in escrow at the opening of the escrow referred to herein.
>
> (ii) On or before May 1, 1969, the balance of such prepaid interest.
>
> (b) On February 1, 1969, and on the first day of each month thereafter until December 31, 1969, the sum of $15,000. By arrangements to be effected through the escrow referred to herein, each of such $15,000 monthly payments shall be deposited in an interest bearing account, subject to the following conditions:
>
> (i) During the period beginning February 1, 1969, and ending December 30, 1970, the Buyer may withdraw all or any part of such payments, including any interest earned by such account, only for the purpose

of making capital improvements upon the property to satisfy the requirements of a tenant or tenants of the Buyer who have requested capital improvements as part of their transaction with Buyer.

(ii) On January 1, 1971, the Seller shall have the unrestricted right to withdraw any of the remaining funds, with accrued interest, and the principal of such promissory note shall be credited with the amount withdrawn, but any interest earned by such account and not previously withdrawn by the Buyer, shall be paid to the Seller without credit to the principal and interest of such promissory note.

• • • • •

(c) On January 1, 1970, and on the first day of each month thereafter until December 31, 1971, the sum of $10,000 plus 50% of gross rents received by the Buyer during the preceding calendar month, excluding from such gross rents an amount equal to the monthly rent of $27,023.74 payable by the State of California under its present lease. Such payments shall be applicable to the principal of the promissory note.

(d) (i) On January 1, 1972, and on the first day of each month thereafter until December 31, 1974, the minimum sum of $15,000, or $10,000 plus 50% of gross rents received by the Buyer during the preceding calendar month • • •

(ii) On January 1, 1972, the Buyer is granted the right and option to prepay interest in one or more installments of prepaid interest for the period beginning January 1, 1972 and ending December 31, 1975.

(e) On January 1, 1975, and on the first day of each month thereafter until December 31, 1977, the minimum sum of $20,000, or $10,000 plus 50% of gross rents

> received by the Buyer during the preceding calendar month * * *
>
> (f) On or before December 31, 1978, all remaining payments of principal and interest at 8% per annum shall be made. In any event, any unpaid principal and interest shall become due and payable at the end of ten years from the closing.
>
> (g) The Buyer, however, shall have the right to prepay principal at any time without penalty. * * *

On November 25, 1968, the Holgersons' offer was signed on behalf of Aerojet by Robert Mackenzie, president, and James N. Ebright (Ebright), secretary and general counsel. On November 25, 1968, Ebright read to Julian Stern (Stern), attorney for the Holgersons, over the telephone a letter addressed to Stern from Ebright suggesting several changes in the Holgersons' offer. Stern indicated to Ebright his agreement with the changes suggested in the letter.

On December 19, 1968, the Holgersons and Aerojet entered into an Agreement Surviving Escrow which provided for payments to be made as set forth in subparagraph 1(b) of the Holgersons' offer as amended by the Aerojet letter of November 25, 1968. Such Agreement Surviving Escrow read, in part, as follows:

> In this connection, Buyer agrees on February 1, 1969, and on the first day of each and every month thereafter, up to and including December 1, 1969, to deposit the sum of $15,000.00 in an interest bearing account at the bank designated in paragraph 3 below, subject to the following conditions:

a. During the period beginning February 1, 1969, and ending December 31, 1970, the Buyer may withdraw, subject to written approval of the Seller, all or any part of such payments, including any interest earned by such account, for the sole purpose of making capital improvements upon the property to satisfy the requirements of a tenant or tenants of the Buyer who have requested, in writing, capital improvements as part of their transaction with the Buyer.

b. On January 1, 1971, the Seller shall have the unrestricted right to withdraw any of the remaining funds with accrued interest from said interest bearing account and the amount of the $2,650,000.00 promissory note shall be credited on the date of withdrawal with the amount withdrawn, excepting any interest earned by such account and not previously withdrawn by the Buyer, shall be retained by the Seller without credit to the principal and interest of said promissory note.

On December 18, 1968, the Holgersons executed a promissory note in favor of Aerojet with payments of principal and interest to be made as set forth in subparagraphs 1(c),(d),(e),(f), and (g) of their November 23, 1968, offer, as modified by the Aerojet letter of November 25, 1968. Such promissory note also included the following provisions:

A. *Principal:*

Principal shall be payable in monthly installments on the following dates:

1. Commencing on January 1, 1970, and continuing on the first day of each month thereafter to and including December 1, 1971, the sum of TEN THOUSAND AND 00/100 DOLLARS ($10,000.00), plus the

further monthly sum equal to fifty per cent (50%) of all gross rentals derived from the real property, including the buildings and improvements located thereon, described in the Deed of Trust securing this Note and hereinafter mentioned, excluding, however, an amount equal to the gross rents not exceeding the amount of TWENTY-SEVEN THOUSAND TWENTY-THREE AND 74/100 DOLLARS ($27,023.74) per month derived from that certain Lease, as amended (hereinafter called "State of California Lease") dated November 16, 1965, between AEROJET-GENERAL CORPORATION, payee above named, as Lessor, and State of California, as Lessee, covering a portion of the building or buildings located on the aforementioned real property.

2. Commencing on January 1, 1972, and continuing on the first day of each month thereafter to and including December 1, 1974, the greater of the following sums each month during said 24 months period, namely, (a) the sum of FIFTEEN THOUSAND AND 00/100 DOLLARS ($15,000.00), or (b) the sum of TEN THOUSAND AND 00/100 DOLLARS ($10,000.00), plus the further monthly sum equal to fifty per cent (50%) of all gross rentals derived from the aforesaid real property, including the building and improvements located thereon described in said Deed of Trust, excluding, however, an amount equal to the gross rents not exceeding the amount of TWENTY-SEVEN THOUSAND TWENTY-THREE AND 74/100 DOLLARS ($27,023.74) per month derived from said State of California Lease.

3. Commencing on January 1, 1975 and continuing on the first day of each month thereafter to and including December 1, 1978, the greater of the following

sums each month during said 36 months period, namely, (a) the sum of TWENTY THOUSAND AND 00/100 DOLLARS ($20,000.00), or (b) the sum of TEN THOUSAND AND 00/100 DOLLARS ($10,000.00), plus the further monthly sum equal to fifty per cent (50%) of all gross rentals derived from the aforesaid real property, including the building and improvements located thereon described in said Deed of Trust, excluding, however, an amount equal to the gross rents not exceeding the sum of TWENTY-SEVEN THOUSAND TWENTY THREE AND 74/100 DOLLARS ($27,023.74) per month derived from said State of California Lease.

* * * * *

Interest at the rate of seven per cent (7%) per annum on unpaid principal from date of closing to and including December 31, 1971, shall be paid in advance on or before May 1, 1969. Such interest shall be based on unpaid principal as reduced by payment of regular monthly principal installments [of $10,000.00 per month] * * * to be made in discharge of unpaid principal. In the event of payment of principal derived from rental installments payable [$10,000 plus 50% of gross rentals] * * * or by reason of principal prepayments, the makers hereof shall be entitled to be credited accordingly based upon prepayments of interest computed upon principal which has not taken into account reduction in principal arising out of payment of rental installments or principal prepayments.

* * * * *

2. *Principal.*

The undersigned hereby further reserve the right to prepay, without bonus or prepayment charge, the whole or any part of the principal amount of this Note at any time during the term hereof.

On December 19, 1968, the Holgersons executed a deed of trust of City Annex to Western Title Insurance Co. as trustee with Aerojet as beneficiary.

On December 20, 1968, escrow as to Aerojet's sale of the City Annex property was closed. At such closing the December 18, 1968, promissory note executed by the Holgersons was delivered to Aerojet. At the same time $400,000 was paid to Aerojet and designated as prepaid interest on the December 18, 1968, note. Of such amount, $300,000 was paid by the Holgersons, $50,000 by Paul F. Roemer, Jr. (Roemer), and $50,000 by Robert S. Brickell (Brickell). On May 1, 1969, $156,500 was paid to Aerojet and designated as prepaid interest. Of such amount, $145,200 was paid by the Holgersons, $5,650 by Roemer, and $5,650 by Brickell.

The Holgersons purchased City Annex on behalf of Roemer, Brickell, and themselves. During the last week of April 1969, the Holgersons, Roemer, and Brickell entered into an agreement with the Western Title Insurance Co. providing that the Holgersons have an 80-percent undivided interest, Roemer a 12-percent undivided interest, and Brickell an 8-percent undivided interest in City Annex. Such agreement provided further:

> Eighty percent (80%) of the down payment, including prepaid interest on the purchase price and closing costs on the property, shall be contributed by the Holgersons, ten percent (10%) thereof shall be contributed by Roemer, and ten percent (10%) thereof shall be contributed by Brickell. * * *

Such agreement specifically stated that the Holgersons, Roemer, and Brickell were not partners.

In addition to the prepaid interest, payments of interest and principal were made on the December 18, 1968, note by the Holgersons, Roemer, and Brickell as follows:

Year	Interest	Principal
1969		
1970		$156,083.95
1971		276,984.79
1972	$133,034.50	151,320.14
1973	156,887.86	90,000.00
1974	146,812.88	180,135.85
1975	134,499.08	240,000.00
1976 (through Nov. 30)	106,734.80	220,000.00

Partnership returns were filed by the Holgersons, Roemer, and Brickell for 1968 and 1969 with respect to the operation of City Annex which showed net losses of $377,802 in 1968 and $136,013 in 1969. These returns were prepared on the cash method and included deductions of $400,000 for interest in 1968 and $156,500 in 1969. The Holgersons, Roemer, and Brickell deducted their shares of the City Annex losses on their individual returns as follows:

	1968	1969
Holgersons	$282,242	$128,810
Roemer	47,335	3,192
Brickell	48,225	4,011

In his notices of deficiency, respondent treated the $400,000 designated as prepaid interest in 1968 and the $146,500 designated as prepaid interest in 1969 to be deductible only to the extent of $5,560 in 1968 and $185,500 in 1969.

3. *Pine Terrace*

On December 21, 1967, Holgerson entered into an agreement to purchase property known as Pine Terrace from

the Duffel-Smoot Cos. (Duffel-Smoot) for $1 million. Under the December 21, 1967, agreement, Holgerson was to assume an existing first mortgage of approximately $650,000 and execute a $350,000 note in favor of the seller and secured by a second deed of trust with interest at 8 percent and a term of 10 years. The terms of such note were to provide that Holgerson prepay $210,000 as 7½ years' interest, that principal payments on the note would not begin for 7½ years, and that the note might be paid in full by Holgerson at the end of 7½ years at the discounted amount of $275,000.

On December 27, 1967, the Holgersons executed a note for $274,759.03 with interest from December 31, 1967, at 8 percent per annum, and principal and interest payable in $3,000 installments on the first day of each month beginning October 31, 1974, until December 31, 1977, on which date the unpaid principal and interest thereon would become due and payable, except if the note were paid on or before October 31, 1974, $199,759.03 would be payment in full. During September 1974, the Holgersons paid Duffel-Smoot $199,759.03.

On December 29, 1967, escrow was closed and the Holgersons paid the purchase price by assuming a first mortgage of $655,240.97, transferring their note for $274,759.03, and paying $70,000 in cash. At the close of escrow, the Holgersons also paid to Duffel-Smoot $150,201.52 designated as prepaid interest on the December 27, 1967, note for the period up to October 31, 1974. Such amount was deducted by the Holgersons in their joint return for the taxable year 1967, and respondent disallowed the entire deduction in his statutory notice.

4. Royal Ann

On September 2, 1967, Oaks Investment Co. (Oaks), a partnership, entered into a contract of sale with Prospect Hill Building Co. (Prospect Hill), a corporation, to sell property known as Royal Ann Apartments, which it then owned, for $435,000. On April 30, 1968, a partner of Oaks, wrote to Prospect Hill that the sales contract on the Royal Ann Apartments had been broken because of nonpayment of certain specified items and that it would consider a new sales contract at a later date.

On September 10, 1968, the Holgersons executed a note in favor of Regal Servi-Center, Inc. (Regal), in the face amount of $160,000 ($160,000 note) with interest from September 13, 1968, on the unpaid principal at the rate of 8½ percent per year, payable in advance to September 13, 1976. Such note also provided that principal and interest were payable in monthly installments of $2,534.40 or more on the 13th of each month beginning October 13, 1976, but such note might be satisfied in full by payment of $104,000 on or before September 13, 1976. Such note was due in its entirety on or before September 10, 1983. To secure such note, the Holgersons also executed on September 10, 1968, a deed of trust to the Royal Ann Apartments.

On September 10, 1968, Duncan Hole (Hole) executed a note ($60,000 note) on behalf of Regal payable to Oaks in the amount of $60,000 with interest on the unpaid amount from September 10, 1968, at a rate of 8 percent per year. The $60,000 note also provided for monthly installments of $600 or more beginning October 15, 1968.

On September 13, 1968, Regal assigned to Oaks its rights in the $160,000 note and its rights under the deed of trust relating to the Royal Ann Apartments to the extent of $60,000 with the provision that such note and deed of trust be reassigned upon payment in full of the $60,000 note.

On September 13, 1968, the escrow relating to the Holgersons' purchase of the Royal Ann Apartments was closed. The stated purchase price of $465,000 which Oaks received consisted of the Holgersons' assumption of an outstanding loan on the Royal Ann Apartments in the amount of $256,980.90, the $60,000 note from Regal and the remainder, less costs of the transaction, in cash. The Holgersons deposited $152,011.13 into the escrow relating to their purchase of the Royal Ann Apartments. Such amount was disbursed as follows:

Assumption fee	$ 20.00
To Regal	8,800.00
Recording fees	4.80
Title insurance fee	1,572.50
Preparing documents	20.00
Commission (less credits)	15,039.55
U.S. revenue stamps	229.90
To Oaks	126,324.38
Total	$152,011.13

The remaining $100,000 of the $108,800 amount credited to Regal and designated as prepaid interest on the $160,000 note was withheld from the proceeds of such note.

During September of 1969, Regal transferred the $160,000 note to Oaks in satisfaction of its obligation under the $60,000 note. Before September 13, 1976, the Holgersons paid $104,000 to Oaks in satisfaction of their obligation under the $160,000 note.

On their 1968 return, the Holgersons deducted $108,800 as interest prepaid on the $160,000 note. In his notice of deficiency, respondent disallowed such deduction in full.

5. *Riverside Motelodge*

On April 13, 1963, Maurice Weiss and Edna Weiss, his wife (the Weisses), who owned certain land situated in Riverside, Calif., entered into a lease of such property for 53 years commencing March 1, 1963, with Western Motorlodge (Western). Western contemplated constructing and operating a motel, restaurant, and possibly a cocktail lounge on such property. Such lease provided, in part, as follows:

> 9. *Assignment*
>
> Lessee may assign this Lease, or any interest therein, or any right or privilege appurtenant thereto, under the following provisions:
>
> (a) The Assignee shall be able to show a net worth, as the term is recognized by Certified Public Accountants in California, in the sum of at least TWO HUNDRED THOUSAND DOLLARS ($200,000.00).
>
> (b) Such Assignee shall, in writing, expressly agree that any such assignment shall be subject to all of the terms of this Lease, and that such Assignee shall add, in writing, for the benefit of Lessors, a covenant to comply with all of the terms of this lease.

Paragraph 9 was not affected by an addendum to the April 13, 1963, lease which was executed on May 10, 1963. Prior to September 1, 1968, Western had built a motel facility on the leased property (hereinafter referred to as Riverside Motelodge).

On September 1, 1968, Holgerson entered into an agreement with Western to purchase Western's leasehold interest in the Riverside Motelodge, together with certain personal property, for a total consideration of $700,000 consisting of the Holgerson's taking subject to, or assuming, the existing loan of $305,000 to which Western's leasehold interest was subject, a cash downpayment of $35,000, and Holgerson's $360,000 note. The September 1, 1968, agreement also provided for Holgerson to pay $216,000 cash as prepaid interest on the $360,000 note and for Western to lease back Riverside Motelodge. The September 1, 1968, agreement was subject to the execution of such leaseback in a form satisfactory to Holgerson and his attorney and the written approval of Western's financial responsibility by Holgerson and his attorney.

On November 25, 1968, Western executed an assignment of the April 13, 1963, lease to Holgerson. Also on November 25, 1968, Holgerson leased his Riverside Motelodge interest back to Western for a term of 15 years commencing December 1, 1968.

On December 19, 1968, the Weisses certified by document that they owned fee title to the Riverside Motelodge, the rent on the April 13, 1963, lease had been paid up to and including December 31, 1968, and they had not declared a default of any term of that lease. In such document, they also consented to and approved the assignment of the April 13, 1963, lease to Holgerson on the condition that he sign an agreement (1) accepting the assignment of such lease subject to all the terms and conditions of the lease, (2) assuming liability for future rents under the lease, (3) agreeing

to comply with each and every one of the terms and conditions of the lease, and (4) assuming the indebtedness to which the property was subject and holding the Weisses harmless from such indebtedness.

On December 20, 1968, the Riverside Motelodge transaction was closed. At such time, Holgerson took the Riverside Motelodge leasehold interest subject to an existing deed of trust in the amount of $305,000, paid $35,000 cash to Western, and transferred to Western his note dated November 25, 1968, in the amount of $360,000 secured by a second deed of trust. The terms of the $360,000 note was 15 years with interest on said note's anniversary date at the rate of 12 percent per annum for the first 5 years and thereafter at a rate of 7 percent per annum until the principal amount was paid in full. Such note also required the prepayment of 2½ years' interest on the date of the note and prepayment of interest for the next 2½ years on or before January 2, 1969. By its terms, such note could be satisfied at any time within 5 years from its date of execution by a payment of $165,000 plus all accrued interest. By 1972, Holgerson had paid $165,000 on the principal of such note.

On November 25, 1968, Holgerson deposited into escrow an amount including $90,500 which was transferred to Western upon closing and designated as prepaid interest on his note. On December 27, 1968, Holgerson paid to Western $500 designated as prepaid interest on his note. On January 2, 1969, Holgerson paid to Western $125,000 designated as prepaid interest on his note. Holgerson deducted such amounts designated as prepaid interest on his Federal tax

returns for the years 1968 and 1969. In his statutory notice, respondent disallowed such deductions in full.[3]

OPINION

1. *Walgro*

The Holgersons argue that Rev. Rul. 68-643, 1968-2 C.B. 76,[4] is not applicable to their $250,000 interest prepayment

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[3]While respondent disallowed $91,208 as an interest deduction for 1968 with respect to the Riverside Motelodge transactions, Holgerson in his brief only claims that he is entitled to a deduction of $91,000. It is unclear for what the additional $208 was deducted.

[4]"Reconsideration has been given to I.T. 3740, C.B. 1945, 109, concerning the question whether interest paid in advance is deductible for Federal income tax purposes for the year in which paid.

"I.T. 3740 was based upon a transaction in which the taxpayer paid interest in advance for a period of five years. As to such transaction, I.T. 3740 holds that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements method of accounting, interest paid in advance for a period of 5 years is deductible for the year in which paid, but where the accrual method of accounting is used in reporting income, interest is deductible for the year in which the liability to pay accrues irrespective of when payment is actually made.

"Section 163 of the Internal Revenue Code of 1954 provides, in general, that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

"Section 446(a) of the Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) of the Code provides, in part, that if the method used does not clearly reflect income the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"As to taxpayers employing the accrual method of accounting, consistent with the position stated in I.T. 3740, interest accrues

in the Walgro transaction, because Rev. Rul. 68-643 specifically provides that it will be applied without retroactive effect, pursuant to the authority contained in section

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ratably over the period of the loan and is allowable as a deduction ratably over this period, irrespective of when paid.

"In view of certain abuses which have arisen with respect to prepayment of interest by taxpayers using the cash receipts and disbursements method of accounting, the Service has reexamined its position in I.T. 3740. The Service now concludes that the deduction of prepaid interest in the year of payment by a taxpayer employing the cash receipts and disbursements method of accounting may not result in a clear reflection of income for the taxable year of payment. A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted. Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason of prepayment, and the existence of a varying rate of interest over the term of the loan. If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved.

"In view of the foregoing, I.T. 3740 is revoked. However, pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will be applied without retroactive effect to interest prepayments for periods not in excess of five years made prior to November 26, 1968 by taxpayers employing the cash receipts and disbursements method of accounting. This Revenue Ruling also will be applied without retroactive effect to an interest prepayment

7805(b),[5] "to interest prepayments for periods not in excess of five years made prior to November 26, 1968, by taxpayers employing the cash receipts and disbursements method of accounting." The $250,000 prepayment made by the Holgersons was only sufficient to meet their interest obligations on the December 13, 1967, note for approximately 3⅔ years. However, the Holgersons agree with Walgro that such amount could be applied, at the sole discretion of Walgro, to satisfy the Holgersons' interest obligation on such note for *any* 3⅔ years prior to February 1, 1976.

Respondent argues that the interest prepayment must satisfy obligations arising during a period not in excess of 5 years from the prepayment date in order for the limitation on retroactivity of Rev. Rul. 68-643 to apply. We agree. We believe that such limitation on retroactivity was designed to protect those taxpayers who had relied on I.T.

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for a period not in excess of five years made on or after November 26, 1968, by a taxpayer employing the cash receipts and disbursements method of accounting, pursuant to a legal obligation incurred prior to such date to make such prepayment.

"The Service will no longer follow the contrary decisions in *John D. Fackler v. Commissioner*, 39 B.T.A. 395 (1939), acquiescence, C.B. 1939-1 (Part I), 11, and *Court Holding Co. v. Commissioner*, 2 T.C. 531 (1943), acquiescence, C.B. 1943, 5. Acquiescence in each of those court decisions is being withdrawn and nonacquiescence substituted therefor. * * *"

[5]SEC. 7805. RULES AND REGULATIONS.

(b) Retroactivity of Regulations or Rulings—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

3740, 1945 C.B. 109,[6] from adverse tax consequences. Such ruling provided that "interest paid *in advance for a period of five years* constitutes an allowable deduction for Federal income tax purposes for the year in which paid." (Emphasis supplied.) We believe the emphasis of I.T. 3740, is as much on the length of the period between date of prepayment and the date on which the prepaid interest is actually earned as it is on the number of years' interest that can be satisfied with the prepaid funds. The length of time by which a deduction is taken before the interest is to be earned is as much directly related to the extent of tax deferral and distortion of income which occurs as is the number of years' interest that can be satisfied with the prepaid funds.[7] If this were not so, a debtor could in successive years prepay interest in 5-year increments succeeding one after the other into the distant future.

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[6]26 C.F.R. sec. 601.601(d)(2)(v)(c)(1977), reads, in part, as follows:

"Where Revenue Rulings revoke or modify rulings previously published in the Bulletin the authority of section 7805(b) of the Code ordinarily is invoked to provide that the new rulings will not be applied retroactively to the extent that the new rulings have adverse tax consequences to taxpayers. * * *"

[7]We note that such theory is supported by that portion of Rev. Rul. 68-643, 1968-2 C.B. 76-77, which states:

"A deduction for interest paid *in advance* on each indebtedness for *a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made* will be considered on a case by case basis to determine whether a material distortion of income has resulted. * * * If interest is prepaid for a period *extending more than 12 months beyond the end of the current taxable year,* the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. * * * [Emphasis supplied.]"

In the instant case Walgro applied the $250,000 interest prepayment to satisfy the Holgersons' interest obligations for part of 1973 and all of 1974 through 1976, so that none of such prepayment was applied to satisfy interest obligations arising during the taxable year in which such prepayment was made or the 5 taxable years thereafter. Accordingly, we hold that the limitation on the retroactivity of Rev. Rul. 68-643 is not applicable to such prepayment of interest and without deciding the validity of Rev. Rul. 68-643 in all cases,[8] we hold that the Holgersons have not met their burden of overcoming respondent's determination[9] that their treatment of prepaid interest fails to clearly reflect income. *Cole v. Commissioner*, 64 T.C. 1091 (1975). This payment is one of several substantial prepayments of interest which the Holgersons made at the end of a taxable year when their income from the sale of airplane parts had substantially increased, the Holgersons have not shown

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[8]We have consistently declined to decide whether everything said in such ruling is valid or whether such ruling may be validly applied in all cases to which it purports to apply. *Cole v. Commissioner*, 64 T.C. 1091 (1975); *Burck v. Commissioner*, 63 T.C. 556 (1975), aff'd. 533 F.2d 768 (2d Cir. 1976); *Sandor v. Commissioner*, 62 T.C. 469 (1974), aff'd. 536 F.2d 874 (9th Cir. 1976).

[9]On brief, respondent abandoned his contention that the prepayment should be deducted ratably (along with the annual interest payments which they began to make in 1968) over the term of the note at 5.7732 percent (the average of the 7- and 4½-percent rates to be paid under the note). Respondent now takes the position that the interest rates should not be averaged and contends that the $250,000 amount of prepaid interest should be allocated and deducted, together with the annual interest payments made by the Holgersons to the sellers, at a rate of seven percent of the unpaid balance as specified in the note. Under such approach, for the years in issue the Holgersons will be allowed to deduct $3,350.27 (18/366 of 7 percent) in 1967, and $68,122.22 in both 1968 and 1969.

that such prepayment was required in order to reach an agreement with Walgro, and while the Holgersons deducted the entire amount of the prepayment in 1967, none of such amount was *actually applied* to satisfy interest accruing in 1967, and only $3,350.27 (18/366 x 7 percent x $973,174.50) *could have been so applied.*

2. *City Annex*

Petitioners maintain that Rev. Rul. 68-643, *supra,* is inapplicable to the interest prepayments[10] which they made with respect to the City Annex transaction by paying $400,000 on December 20, 1968, and $156,500 on May 1, 1969, because such prepayment was made (1) by a cash method taxpayer (2) for a period not in excess of 5 years (3) pursuant to a legal obligation, incurred prior to November 26, 1968, to make such prepayment. Respondent argues that petitioners have not met either of the latter two of such requirments. We hold that the interest prepayment in question does not meet the requirements of the clause limiting retroactive application of Rev. Rul. 68-643, because it was made for a period in excess of 5 years. Therefore, we do not reach the question of whether such prepayment was made pursuant to a legal obligation, incurred prior to November 26, 1968, to make such prepayment.

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[10]Even though the prepayment of interest was made in two installments, we treat the two installments as *one* prepayment of interest for purposes of Rev. Rul. 68-643, 1968-2 C.B. 76, because they were both made pursuant to the Dec. 18, 1968, note which required that interest "shall be paid in advance on or before May 1, 1969." The parties have not argued that the installment should be treated separately for purposes of Rev. Rul. 68-643.

In the City Annex transaction, petitioners prepaid interest in an amount equal to approximately 3 years' interest at 7 percent per annum on a principal amount of $2,650,000. However, there were various provisions in the promissory note and Agreement Surviving Escrow under which petitioners could (and to some extent were required to) reduce the principal amount of such note during the 3-year period following its execution. Of course, to the extent that the principal was reduced by credits, required payments, and optional prepayments, the interest accruing during the first 3-year period would also be reduced and the amount of interest prepaid by petitioners could be sufficient (especially if there were principal prepayments) to satisfy interest accruing for a period in excess of 5 years. Therefore, we hold that such prepayment was made for an indefinite period, and although it may be that such indefinite period might not, and did not in fact, exceed a period of 5 years, we do not believe the language regarding retroactivity of Rev. Rul. 68-643, was intended to include prepayments for indefinite periods where there is at least a probability that they may extend beyond 5 years. A narrow interpretation of the language in Rev. Rul. 68-643, limiting its retroactivity is supported by the language of section 7805(b)[11] as well as by 26 C.F.R. sec. 601.601(d)(2)(v)(c)(1977), which states:

> (c) Revenue Rulings, other than those relating to the qualification of pension, annuity, profitsharing, stock bonus, and bond purchase plans, apply retro-

[11](b) Retroactivity of Regulations or Rulings.—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

> actively unless the Revenue Ruling includes a specific statement indicating, under the authority of section 7805(b) of the Internal Revenue Code of 1954, the extent to which it is to be applied without retroactive effect. Where Revenue Rulings revoke or modify rulings previously published in the Bulletin the authority of section 7805(b) of the Code ordinarily is invoked to provide that the new rulings will not be applied retroactively to the extent that the new rulings have adverse tax consequences to taxpayers. Section 7805(b) of the Code provides that the Secretary of the Treasury or his delegate may prescribe the extent to which any ruling is to be applied without retroactive effect. The exercise of this authority requires an affirmative action. * * *

and by *Matson Navigation Co. v. Commissioner*, 68 T.C. 847, 852 (1977), in which we stated as follows:

> We agree with the Commissioner that pursuant to section 7805(b) revenue rulings, which interpret statutory provisions, are generally retroactive, and that affirmative action on his part is required to make such rulings nonretroactive.

Moreover, even if the language limiting retroactivity of Rev. Rul. 68-643 were read so broadly as to cover the prepayment at issue, I.T. 3740 would still not be applicable to such prepayment unless it were for a period not in excess of 5 years. We cannot read I.T. 3740 so broadly as to cover a prepayment for an indefinite period which may possibly extend beyond 5 years. 26 C.F.R. sec. 601.601(d)(2)(v)(e) states:

> (e) Taxpayers generally may rely upon Revenue Rulings published in the Bulletin in determining the

> tax treatment of their own transactions and need not request specific rulings applying the principles of a published Revenue Ruling to the facts of their particular cases. *However, since each Revenue Ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same.* • • • [Emphasis supplied.]

Accordingly, we hold that Rev. Rul. 68-643 is applicable to the interest prepayment made by petitioners in connection with the City Annex transaction, and, without approving the application of Rev. Rul. 68-643 to all situations within its scope, we hold that petitioners have not met their burden of overcoming respondent's determination that their treatment of prepaid interest fails to clearly reflect income. *Cole v. Commissioner, supra.* Petitioners made the $400,000 prepayment installment near the end of the taxable year 1968, and deducted the entire amount of such prepayment although interest equaling only $5,575.14, or approximately 3 percent of the prepayment, was earned during the taxable year, and petitioners deducted the entire $156,500 prepayment installment made in 1969 although none of such amount was necessary to satisfy interest obligations arising during 1969 because of the prior $400,000 prepayment.[12] Moreover, it has not been shown

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[12] We note that petitioners made a larger prepayment on May 1, 1969, than required. The Dec. 18, 1968, note required a 1969 prepayment which, together with the prior $400,000 prepayment, was sufficient to satisfy interest at a rate of 7 percent from the date of closing to Dec. 31, 1971, based on the principal amount *as reduced*

that any prepayment was necesary to reach an agreement for petitioners' purchase of the City Annex property. We hold that the interest prepayment must be deducted pro rata over the years during which it is earned.

Petitioners' argument that Rev. Rul. 68-643 is applicable only to that portion of their prepayment which prepaid interest for a period commencing more than 5 years from the date of prepayment is without merit. Petitioners cite no cases in support of such position and we have found none. Moreover, there is nothing in the language of Rev. Rul. 68-643 or I.T. 3740 supporting their position. I.T. 3740 was merely a statement of an administrative position that the current deduction of interest prepayments for a period which *in its entirety* did not exceed 5 years would not be challenged. It is clear that the longer the prepayment period, then the greater is the possibility that income will be distorted and that tax avoidance motives are present. As stated *supra* at page 454 the language limiting retroactivity of Rev. Rul. 68-643 was designed to protect taxpayers from adverse tax consequences to the extent that they had relied on I.T. 3740 so that retroactivity should be limited, if the other conditions limiting retroactivity are met, only where the interest prepayment as a whole is for a period not in excess of 5 years.

3. *Pine Terrace*

Respondent argues that in substance the principal amount of the December 27, 1967, note was equal to the

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by the required minimum principal payments. However, petitioners' prepayments were in an amount computed as 3 years' interest at 7 percent on an *unreduced* principal amount of $2,650,000.

stated principal amount less the discount for prepayment, or $199,759.03, so that the Holgersons' basis of Pine Terrace should be decreased accordingly, and so that a portion of the amount designated as prepaid interest on $274,759.03 was in fact part of the purchase price, not interest.

Under section 1012, the Holgersons' basis of the Pine Terrace property is "the amount paid for such property in cash or other property." Sec. 1.1012-1(a), Income Tax Regs. It is clear that a purchase-money debt obligation, such as the Holgersons' note, for part of the purchase price will be included in basis. *Mayerson v. Commissioner*, 47 T.C. 340 (1966). However, we must determine the amount which the Holgersons were obligated to pay in substance since this is the proper amount to include in their basis of Pine Terrace. *Gregory v. Helvering*, 293 U.S. 465 (1935).

The Holgersons could fully satisfy their obligations under the note (1) by a principal payment of $199,759.03 on or before October 31, 1974, or (2) by a principal payment of $274,759.03, less the amount of prior principal payments, on or before December 31, 1977. *Mayerson v. Commissioner, supra*, involved a note for a term of 99 years with a stated principal amount of $332,500 providing that if the required principal payments totaling $10,000 and all interest due had been paid, such note could be satisfied in full by a payment of $275,000 within the first year and by a payment of $298,750 within the second year of the note's term. In *Mayerson* we stated (47 T.C. at 354):

> There were only two variables in the overall purchase price of the property, and they were specified in dollar amounts. The price depended then upon whether the purchase-money mortgage was paid within the first

> year, the second year, or years thereafter. We would classify such a price reduction for early payment as a bonus discount. The presence of such optional discounts does not make the purchase price indefinite. *It merely provided an incentive for very early retirement of the mortgage which did not occur.* The cost basis at the time of purchase should be the nondiscount price; the entire principal of the note and mortgage was due unless the discounted sums were paid in the first 2 years. It was not prepaid so as to provide for the application of the discount provisions and hence no adjustment in basis is required during the years before us. * * * [Emphasis supplied.]

We believe the instant case is distinguishable from *Mayerson* because (1) the discount provided in the Holgersons' note cannot be fairly classified as a discount for early payment, and (2) the Holgersons did in fact satisfy their note for the discounted amount, and at the time of purchase there was not a substantial possibility that they would ever pay the stated principal amount of $274,759.03 in full. In *Mayerson*, the discount was available only for payment during the first 2 years of a note for a term of 99 years, and the amount of the available discount was approximately 15 percent for payment during the first year and approximately 7 percent for payment during the second year of the note's term. By contrast, the Holgersons could receive a discount of over 27 percent for payment at any time during the first 6 years and 10 months of a note for a term of only 10 years. Since the terms of such discount were so favorable, we do not believe there was a substantial likelihood that payment would not be made within the first 6 years and 10 months of the note so as to receive such discount. Even if the Holgersons had to borrow in order to pay the note within such

period, we believe that persons with their business acumen and contacts would be able to secure a second mortgage for $199,759.03 at an interest rate sufficiently low so that it would be profitable to take advantage of the available discount with such borrowed funds. In fact, the Holgersons did subsequently satisfy their obligations under the note by payment of the discounted amount. We cannot allow the Holgersons a cost basis at the time of purchase, including their note at the nondiscount price of $274,759.03, where there is not at least a substantial probability that such amount will ever be paid in full. To allow such inflated basis, would permit excessive depreciation deductions and tax deferral for as many as 6 years until the Holgersons satisfied their note for the discounted amount of $199,759.03 and their basis was decreased to reflect such fact. Accordingly, we find that the December 27, 1967, note should be included in the Holgersons' basis of Pine Terrace at the amount of $199,759.03.

For an amount to be deductible pursuant to section 163, it must have been paid on an existing, unconditional, and legally enforceable obligation. *Titcher v. Commissioner,* 57 T.C. 315 (1971); *Kovtun v. Commissioner,* 54 T.C. 331 (1970), affd. 448 F.2d 1268 (9th Cir. 1971). The Holgersons' obligation on their note was unconditional only to the extent of $199,759.03, (*Michelin Corp. v. McMahon,* 137 F. Supp. 798 (S.D.N.Y. 1956)), but the $150,201.52 prepayment was computed as interest for 6 years and 10 months at 8 percent per annum on a principal amount of $274,759.03. Moreover, we are not convinced that the favorable discount provisions on the December 27, 1967, note would have been included if it had not been for the fact

that the Holgersons were making a large prepayment of interest. Thus, we believe that a portion of the $150,201.52 prepayment represented in reality a payment on the purchase price of Pine Terrace. Accordingly, we hold that only the portion of the $150,201.52 prepayment equaling $109,201.60 (computed as interest for 6 years and 10 months at a rate of 8 percent per annum on a principal amount of $199,759.03) represents interest paid on indebtedness for section 163 purposes and the remainder of the $150,201.52 is a payment on the purchase price of Pine Terrace and the Holgersons' basis of Pine Terrace should be adjusted accordingly.

In any event, the amount which does represent prepaid interest is not deductible in the year of payment because such deduction would materially distort the Holgersons' income. I.T. 3740, 1945 C.B. 109, is inapplicable because the prepayment exceeds 5 years and we hold that deducting the entire amount of such prepayment in 1967 would materially distort the Holgersons' income since it was paid at the end of a year in which the Holgersons' income had substantially increased over past years, very little interest was actually earned in the year of payment, and there is no evidence that prepaid interest was required to reach an agreement with respect to the purchase of Pine Terrace. Accordingly, we hold that the $109,201.60 amount must be deducted pro rata over the years for which it was paid.

4. *Royal Ann*

Respondent first argues that the Holgersons only "paid" $8,800 during 1968 for section 163(a) purposes[13] because the Holgersons only paid such amount in cash and the remaining $100,000 of the amount designated as prepaid interest was withheld from the proceeds of the $160,000 note. It is well established that a cash basis borrower has not paid interest when the lender withholds as interest a certain sum from the face amount of the loan and only makes available the proceeds in excess of the interest obligation as was done by Regal in the instant case. *Rubnitz v. Commissioner*, 67 T.C. 621, 628 (1977), and cases cited therein. Moreover, even if the entire proceeds of the $160,000 note had been deposited in the escrow relating to the Holgersons' purchase of the Royal Ann Apartments, the Holgersons would still not have had unrestricted control over the proceeds, and a "prearranged retransfer of funds" to Regal would not have constituted a "payment" which a cash basis taxpayer could deduct. *Rubnitz v. Commissioner, supra* at 629. Accordingly, for section 163(a) purposes we hold that petitioner "paid" only $8,800 to Regal during 1968.[14]

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[13]SEC. 163. INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

[14]We do not believe this conclusion is inconsistent with the parties' stipulation stating:

"The $108,800.00 paid at the closing of the Holgersons' purchase of the Royal Ann Apartments to Regal Servi-Center, Inc., designated as prepaid interest, was deducted by the Holgersons on their 1968 return as interest."

We interpret the term "paid" as used in such stipulation to have a broader meaning than the technical one which it has for sec. 163(a) purposes.

Respondent argues that none of the $108,800 payment is deductible as interest by the Holgersons in any year because the transaction was a sham designed solely for the purpose of obtaining an interest deduction. We disagree. The Holgersons stood to benefit from the $160,000 debt because it enabled them to purchase the Royal Ann Apartments and, aside from tax benefits, they could realistically anticipate to profit from such transaction. These facts distinguish the instant case from *Goldstein v. Commissioner*, 44 T.C. 284 (1965), affd. 364 F.2d 734 (2d Cir. 1966).

Respondent argues next that, assuming the reality of the indebtedness, there was no substance in Regal's role as lender and that the "real" lender was Oaks. Such argument misses the point.

In *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), the Second Circuit Court of Appeals, in holding that the *indebtedness* on which interest is paid must be incurred in order to engage in some purposive activity, did not apply a purposive test to the interest that was paid on such indebtedness. The court stated (364 F.2d at 741):

> there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable. 4 Mertens, Law of Federal Income Taxation § 26.01 (1960 ed.). • • •
>
> Section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words,

> the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. * * *

Even if Oaks were the "real" lender, the fundamental facts remain that the Holgersons were obligated under the $160,000 note; they paid the principal amount, according to the terms of such note, to Oaks as assignee; the indebtedness was incurred so that the Holgersons could purchase and take possession of the Royal Ann Apartments; and the $8,800 was paid for the use and forbearance of money.[15]

The $108,800 amount designated as prepaid interest was computed as 8 years' interest at 8 percent per annum on a principal amount of $160,000. As was the case in Pine Terrace, *supra*, the Holgersons' indebtedness to Regal was unconditional only to the extent of $104,000. *Michelin Corp. v. McMahan, supra.*

However, we need not decide whether the $108,800 amount represented interest only to the extent of $70,720 equaling 8-years' interest at 8½ percent per annum on the $104,000 principal amount for which the Holgersons were unconditionally obligated since the remaining $38,000 of

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[15]Of course if Oaks were the "real" lender, such fact might affect its tax liability for 1968 but Oaks is not a party to this proceeding. However, even if Oaks were the real lender the Holgersons' basis of the Royal Ann Apartments remains unchanged since only $60,000 of the proceeds from the Holgersons' note was applied to the purchase of the Royal Ann Apartments in any event with the remainder withheld and designated as prepaid interest.

the $108,800 amount as well as part of the $70,720 was never actually paid. The Holgersons satisfied their obligations in full by payment of $104,000 in 1976 (thereby repaying only $44,000 of the $100,000 which was withheld from the proceeds of the $160,000 note). Therefore, we hold that the entire $8,800 which was paid in 1968 represented interest.

Sinc the Holgersons only "paid" $8,800 as prepaid interest during 1968, and since such amount represented interest paid in advance for a period of less than 5 years, we hold that the entire $8,800 is deductible by the Holgersons in the year of payment pursuant to I.T. 3740.

5. *Riverside Motelodge*

In the Riverside Motelodge transaction, we are again faced with determining the value at which a note providing for alternative methods of payment is includable in the maker's basis in the purchased property and whether the entire amount designated as prepaid interest which was computed by applying the stated interest rate to the maximum principal amount is "interest paid * * * on indebtedness" for purposes of section 163.

The note which Holgerson executed on November 25, 1968, could be satisfied either by a principal payment of $165,000 before November 25, 1973, or a principal payment of $360,000 on or before November 25, 1983. The large amount of such discount and the long period for which it was available, indicate that it was not merely a discount for early payment so that *Mayerson v. Commissioner, supra,* is distinguishable. It would clearly have been in Hol-

gerson's financial interest to obtain a loan, if necessary, in order to take advantage of the discount for early payment and we find it inconceivable that a person with his business acumen and financial contacts would not have been able to secure a loan with a rate of interest which would allow him to profitably take advantage of the discount. We find that there was no substantial possibility that he would pay the full $360,000 on such note. Of course, Holgerson did take advantage of the early payment discount during 1972. Accordingly, we find that the amount of the November 25, 1968, note was in fact $165,000 and that it should be included in Holgerson's basis of the Riverside Motelodge leasehold interest at such amount.

Holgerson's obligation on the November 25, 1968, note was unconditional, as required for section 163 purposes, *Titcher v. Commissioner, supra,* only to the extent of $165,000, but the $216,000 amount of the interest prepayment was computed as 5 years' interest on $360,000 at a rate of 12 percent per annum. Since the amount of Holgerson's interest prepayment was greater than the amount of the discounted principal payment which would have satisfied the note in full, we conclude that Holgerson paid such larger amount only because the discount provisions would not be included in the November 25, 1968, note unless he agreed to make the $216,000 interest prepayment. Therefore, it follows that the prepayment was made, in part, to secure the advantageous discount provision rather than for the use or forbearance of money, and that part of the $216,000 payment was in reality a payment on the purchase price of the Riverside Motelodge leasehold interest. Accordingly, we hold that the $216,000 payment repre-

sented interest only to the extent of 99,000, equaling 5 years' interest at the rate of 12 percent on the principal amount of $165,000 which the Holgersons were unconditionally obligated to pay, and that the remaining $117,000[16] of such payment was a payment on the purchase price of the Riverside Motelodge leasehold interest, and Holgerson's basis should accordingly be so adjusted.

The parties agree that I.T. 3740, *supra*, is applicable to the $99,000 portion of the $216,000 amount which represents prepaid interest *if* the $216,000 was paid pursuant to a legal obligation incurred prior to November 26, 1968, to make such prepayment. Holgerson was bound to purchase the Riverside Motelodge leasehold interest (and to prepay $216,000) by the September 1, 1968, agreement and Western was bound to sell. It is irrelevant whether the leasehold interest had been effectively assigned prior to November 26, 1968. Western was bound to assign such interest, and although Holgerson may have been released from his obligation to prepay interest if Western was unable to assign it, he was, nevertheless, legally obligated as of September 1, 1968, and the $216,000 payment was subsequently made pursuant to such obligation.[17]

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[16]The amounts representing interest and purchase price should be allocated equally among the installments paid on Nov. 25, 1968 ($90,500), Dec. 27, 1968 ($500), and Jan. 2, 1969 ($125,000).

[17]Although the Sept. 1, 1968, agreement was expressly subject to the execution of a lease of the Riverside Motelodge leasehold interest back to Western in a form satisfactory to Holgerson and his attorney and to the written approval of Western's financial responsibility by Holgerson and his attorney, no issue has been raised with regard to the satisfaction of these conditions prior to Nov. 26, 1968.

Section 1.1201-1(f)(2)(i), Income Tax Regs., defines "binding contract," as follows:

> (i) A binding contract entered into on or before October 9, 1969, means a contract, whether written or unwritten, which on or before that date was legally enforceable against the taxpayer under applicable law. If on or before October 9, 1969, a taxpayer grants an irrevocable option or irrevocable contractual right to another party to buy certain property and such other party exercises that option or right after October 9, 1969, the sale of such property is a sale pursuant to a binding contract entered into on or before October 9, 1969. * * *

The language limiting retroactivity of Rev. Rul. 68-643 uses the term "legal obligation" rather than "binding contract" to make the distinction between a payment made pursuant to a binding contract entered into before November 26, 1968, which did not obligate the purchaser to make a prepayment of interest (Rev. Rul. 68-643 applies retroactively), and a binding contract entered into before November 26, 1968, under which the taxpayer had a "legal obligation" to prepay interest (no retroactive application). Since the September 1, 1968, agreement was a binding contract under which Holgerson was obligated to prepay interest, the instant case is distinguishable from *Cole v. Commissioner, supra,* and *Sander v. Commissioner,* 62 T.C. 469 (1974), affd. 536 F.2d 874 (9th Cir. 1976). Accordingly, we hold that I.T. 3740, *supra,* is applicable and that the $99,000 portion of the $216,000 amount which represents interest paid on indebtedness is deductible in the year of payment.

Decisions will be entered under Rule 155.

Appendix E

Relevant Statutes

INTERNAL REVENUE CODE SEC. 163(a). INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

INTERNAL REVENUE CODE NO. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) Permissible Methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

(d) Taxpayer Engaged in More Than One Business.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

INTERNAL REVENUE CODE SEC. 461(g).

(1) In general.—If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations prescribed by the Secretary, is properly allocable to any period—

(A) with respect to which the interest represents a charge for the use or forbearance of money, and

(B) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.

(2) Exception.—This subsection shall not apply to points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the

area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area.

INTERNAL REVENUE CODE SEC. 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) General Rule.—In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

(b) Limitation on Tax Where Adjustments Are Substantial.—

(1) Three year allocation.—If—

(A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of change, and

(B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase in taxable income were included in taxable income for the year of the change and one-third of such increase were included for each of the 2 preceding taxable years.

(2) Allocation under new method of accounting.—If—

(A) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000, and

(B) the taxpayer establishes his taxable income (under the new method of accounting) for one or more taxable years consecutively preceding the taxable year of the change for which the taxpayer in computing taxable income used the method of accounting from which the change is made,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the net increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if the adjustments required by subsection (a)(2) were allocated to the taxable year or years specified in subparagraph (B) to which they are properly allocable under the new method of accounting and the balance of

the adjustments required by subsection (a)(2) was allocated to the taxable year of the change.

(3) Special rules for computations under paragraphs (1) and (2).—For purposes of this subsection—

(A) There shall be taken into account the increase or decrease in tax for any taxable year preceding the year of the change to which no adjustment is allocated under paragraph (1) or (2) but which is affected by a net operating loss (as defined in section 172) or by a capital loss carryback or carryover (as defined in section 1212), determined with reference to taxable years with respect to which adjustments under paragraph (1) or (2) are allocated.

(B) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314(a)) for such year.

(C) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(c) Adjustments Under Regulations.—In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary may by regulations prescribe, take the adjustments required by subsection (a)(2) into account in computing

the tax imposed by this chapter for the taxable year or years permitted under such regulations.[1]

INTERNAL REVENUE CODE SEC. 1311. CORRECTION OF ERROR.

(a) General Rule.—If a determination (as defined in section 1313) is described in one or more of the paragraphs of section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error shall be corrected by an adjustment made in the amount and in the manner specified in section 1314.

(b) Conditions Necessary for Adjustments.—

(1) Maintenance of an inconsistent position.—Except in cases described in paragraphs (3)(B) and (4) of section 1312, an adjustment shall be made under this part only if—

(A) in case the amount of the adjustment would be credited or refunded in the same manner as an overpayment under section 1314, there is adopted in the determination a position maintained by the Secretary, or

(B) in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314, there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made,

and the position maintained by the Secretary in the case described on subparagraph (A) or maintained by the tax-

payer in the case described in subparagraph (B) is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be.

(2) Correction not barred at time of erroneous action.—

(A) Determination described in section 1312(3)(B).—In the case of a determination described in section 1312(3)(B) (relating to certain exclusions fom income), adjustment shall be made under this part only if assessment of a deficiency for the taxable year in which the item is includible or against the related taxpayer was not barred, by any law or rule of law, at the time the Secretary first maintained, in a notice of deficiency sent pursuant to section 6212 or before the Tax Court, that the item described in section 1312(3)(B) should be included in the gross income of the taxpayer for the taxable year to which the determination relates.

(B) Determination described in section 1312(4).—In the case of a determination described in section 1312(4) (relating to disallowance of certain deductions and credits), adjustment shall be made under this part only if credit or refund of the overpayment attributable to the deduction or credit described in such section which should have been allowed to the taxpayer or related taxpayer was not barred, by any law or rule of law, at the time the taxpayer first maintained before the Secretary or before the Tax Court, in writing, that he was entitled to such deduction or credit for the taxable year to which the determination relates.

(3) Existence of relationship.—In case the amount of the adjustment would be assessed and collected in the same

manner as a deficiency (except for cases described in section 1312(3)(B)), the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in a return, claim for refund, or petition (or amended petition) to the Tax Court for the taxable year with respect to which the determination is made, or if such position is not so mantained, then at the time of the determination.

INTERNAL REVENUE CODE SEC. 7805. RULES AND REGULATIONS.

(a) Authorization.—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) Retroactivity of Regulations or Rulings.—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

(c) Preparation and Distribution of Regulations, Forms, Stamps, and Other Matters.—The Secretary shall prepare and distribute all the instructions, regulations, directions, forms, blanks, stamps, and other matters pertaining to the assessment and collection of internal revenue.

INTERNAL REVENUE CODE SEC. 7482. COURT OF REVIEW.

(a) Jurisdiction.—The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

(b) Venue.—

(1) In general.—Except as otherwise provided in 'paragraphs (2) and (3) such decisions may be reviewed by the United States Court of Appeals for the circuit in which is located—

(A) in the case of a petitioner seeking redetermination of tax liability other than a corporation, the legal residence of the petitioner,

(B) in the case of a corporation seeking redetermination of tax liability, the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in any judicial circuit, then the office to which was made the return of the tax in respect of which the liability arises,

(C) in the case of a person seeking a declaratory decision under section 7476, the principal place of business, or principal office or agency of the employer,

(D) in the case of a person seeking a declaratory judgment under section 7477, the legal residence of such person if such person is not a corporation, or the principal place of business or principal office or agency of such person if such person is a corporation, or

(E) in the case of an organization seeking a declaratory decision under section 7428, the principal office or agency of the organization.

If for any reason no subparagraph of the preceding sentence applies, then such decisions may be reviewed by the Court of Appeals for the District of Columbia. For purposes of this paragraph, the legal residence, principal place of business, or principal office or agency referred to herein shall be determined as of the time the petition seeking redetermination of tax liability was filed with the Tax Court or as of the time the petition seeking a declaratory decision under section 7428, 7476, or 7477 was filed with the Tax Court.

(2) By agreement.—Notwithstanding the provisions of paragraph (1), such decisions may be reviewed by any United States Court of Appeals which may be designated by the Secretary and the taxpayer by stipulation in writing.

(3) Declaratory judgment actions relating to status of certain governmental obligations.—In the case of any decision of the Tax Court in a proceeding under section 7478,

such decision may only be reviewed by the Court of Appeals for the District of Columbia.

(c) Powers.—

(1) To affirm, modify, or reverse.—Upon such review, such courts shall have power to affirm or, if the decision of the Tax Court is not in accordance with law, to modify or to reverse the decision of the Tax Court, with or without remanding the case for a rehearing, as justice may require.

(2) To make rules.—Rules for review of decisions of the Tax Court shall be those prescribed by the Supreme Court under section 2072 of title 28 of the United States Code.

(3) To require additional security.—Nothing in section 7483 shall be construed as relieving the petitioner from making or filing such undertakings as the court may require as a condition of or in connection with the review.

(4) To impose damages.—The United States Court of Appeals and the Supreme Court shall have power to impose damages in any case where the decision of the Tax Court is affirmed and it appears that the notice of appeal was filed merely for delay.

Appendix F

RELEVANT TREASURY REGULATIONS

Reg. § 1.446-1.

(e) Requirement respecting the adoption or change of accounting method.—(1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the

necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, correction of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In

addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve, see the regulations under section 166 of the Code; for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167(b) of the Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

(c) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(iii) A change in the method of accounting may be illustrated by the following examples:

Example (1). Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method

of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example (2). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example (3). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example (4). From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example (5). A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change of method of accounting for inventories.

Example (6). A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations thereunder. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for

deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes". Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example (8). A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

(3)(i) Except as otherwise provided under the authority of subdivision (ii) of this subparagraph, in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within 180 days after the beginning of the taxable year in which it is desired to make the change. The taxpayer shall, to the extent applicable, furnish (a) all information requested on such form, disclosing in detail all classes of items which would be treated differently under the new method of accounting and showing all amounts which would be

duplicated or omitted as a result of the proposed change and (b) the taxpayer's computation of the adjustments to take into account such duplications or omissions. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 481 and the regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

(ii) Notwithstanding the provisions of subdivision (i) of this subparagraph, the Commissioner may prescribe administrative procedures, subject to such limitations, terms, and conditions as he deems necessary to obtain his consent, to permit taxpayers to change their accounting practices or methods to an acceptable treatment consistent with applicable regulations. Limitations, terms, and conditions, as may be prescribed in such administrative procedures by the Commissioner, shall include those necessary to prevent the omission or duplication of items includible in gross income or deductions.

Reg. § 1.461-1. General rule for taxable year of deduction.

(a) General rule.—(1) Taxpayer using cash receipts and disbursements method. Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such

date and at all times thereafter, the lessee was under a binding, legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) Taxpayer using an accrual method.—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which occurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) Other factors which determine when deductions may be taken.—(i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; section 165(e), relating to losses resulting from theft; and section 165(h), relating to an election of the year of deduction of disaster losses.

(4) Deductions attributable to certain foreign income.— In any case in which owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of § 1.905-1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

Reg. § 601.601. Rules and Regulations.

(a) Formulation. (1) Internal revenue rules take various forms. The most important rules are issued as regulations and Treasury decisions prescribed by the Commissioner and approved by the Secretary or his delegate. Other rules may be issued over the signature of the Commissioner or the signature of any other official to whom authority has been delegated. Regulations and Treasury decisions are prepared in the Office of the Chief Counsel. After approval by the Commissioner, regulations and Treasury decisions are forwarded to the Secretary or his delegate for further consideration and final approval.

(2) Where required by 5 U.S.C. 553 and in such other instances as may be desirable, the Commissioner publishes in the Federal Register general notice of proposed rules (unless all persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law). This notice includes (i) a statement of the time, place, and nature of public ruling-making proceedings; (ii) reference to the authority under which the rule is proposed; and (iii) either the terms or substance of the proposed rule or a description of the subjects and issues involved.

(3)(i) This subparagraph shall apply where the rules of this subparagraph are incorporated by reference in a notice of hearing with respect to a notice of proposed rule making.

(ii) A person wishing to make oral comments at a public hearing to which this subparagraph applies shall file his written comments within the time prescribed by the notice of proposed rule making (including any extensions thereof) and submit the outline referred to in subdivision (iii) of this subparagraph within the time prescribed by notice of hearing. In lieu of the reading of a prepared statement at the hearing, such person's oral comments shall ordinarily be limited to a discussion of matters relating to such written comments and to questions and answers in connection therewith. However, the oral comments shall not be merely a restatement of matters the person has submitted in writing. Persons making oral comments should be prepared to answer questions not only on the topics listed in his outline but also in connection with the matters relating to his written comments. In order to be assured of the availability of copies of such written comments or outlines on or before the beginning of such hearing, any person who desires such copies should make such a request within the time prescribed in the notice of hearing and shall agree to pay reasonable costs for copying. Persons who make such a request after the time prescribed in the notice of hearing will be furnished copies as soon as they are available, but it may not be possible to furnish the copies on or before the beginning of the hearing. Except as provided in the preceding sentences, copies of written comments regarding the rules proposed shall not be made available at the hearing.

(iii) A person who wishes to be assured of being heard shall submit, within the time prescribed in the notice of hearing, an outline of the topics he or she wishes to dis-

cuss, and the time he or she wishes to devote to each topic. An agenda will then be prepared containing the order of presentation of oral comments and the time allotted to such presentation. A period of 10 minutes will be the time allotted to each person for making his or her oral comments.

(iv) At the conclusion of the presentations of comments of persons listed in the agenda, to the extent time permits, other persons may be permitted to present oral comments provided they have notified, either the Commissioner of Internal Revenue (Attention: CC:LR:T) before the hearing, or the representative of the Internal Revenue Service stationed at the entrance to the hearing room at or before commencement of the hearing, of their desire to be heard.

(v) In the case of unusual circumstances or for good cause shown, the application of rules contained in this subparagraph, including the 10-minute rule in subdivision (iii), above, may be waived.

(vi) To the extent resources permit, the public hearings to which this subparagraph applies may be transcribed.

(2) Effective date. This paragraph (b) applies only to comments submitted in response to notices of proposed rule making of the Internal Revenue Service published in the Federal Register after June 5, 1974.

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(d) Publication of rules and regulations. (1) General. All internal revenue regulations and Treasury decisions are published in the Federal Register and in the Code of Federal Regulations. See paragraph (a) of § 601.702. The

Treasury decisions are also published in the weekly Internal Revenue Bulletin and the semi-annual cumulative Bulletin. The Internal Revenue Bulletin is the authoritative instrument of the Commissioner for the announcement of official rulings, decisions, opinions, and procedures, and for the publication of Treasury decisions, Executive orders, tax conventions, legislation, court decisions, and other items pertaining to internal revenue matters. It is the policy of the Internal Revenue Service to publish in the bulletin all substantive and procedural rulings of importance or general interest, the publication of which is considered necessary to promote a uniform application of the laws administered by the Service. Procedures set forth in Revenue Procedures published in the Bulletin which are of general applicability and which have continuing force and effect are incorporated as amendments to the Statement of Procedural Rules. It is also the policy to publish in the bulletin all rulings which revoke, modify, amend, or affect any published ruling. Rules related solely to matters of internal practices and procedures are not published; however, statements of internal practices and procedures affecting rights or duties of taxpayers, or industry regulation, which appear in internal management documents, are published in the bulletin. No unpublished ruling or decision will be relied on, used, or cited by any officer or employee of the Internal Revenue Service as a precedent in the disposition of other cases.

(2) Objectives and standards for publication of Revenue Rulings and Revenue Procedures in the Internal Revenue Bulletin—(i)(a) A "Revenue Ruling" is an official interpretation by the Service that has been published in the

Internal Revenue Bulletin. Revenue Rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned.

(b) A "Revenue Procedure" is a statement of procedure that affects the rights or duties of taxpayers or other members of the public under the Code and related statutes or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge.

(ii)(a) The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for the publication of official rulings and procedures of the Internal Revenue Service, including all rulings and statements of procedure which supersede, revoke, modify, amend, or affect any previously published ruling or procedure. The Service also announces in the Bulletin the Commissioner's acquiescences and nonacquiescences in decisions of the United States Tax Court (other than decisions in memorandum opinions), and published Treasury decisions, Executive orders, tax conventions, legislation, court decisions, and other items considered to be of general interest. The Assistant Commissioner (Technical) administers the Bulletin program.

(b) The Bulletin is published weekly. In order to provide a permanent reference source, the contents of the Bulletin are consolidated semiannually into an indexed Cumulative Bulletin. An Index-Digest Supplement System provides a research and reference guide to all matters appearing in the Cumulative Bulletins. These materials are sold by the

Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

(iii) The purpose of publishing revenue rulings and revenue procedures in the Internal Revenue Bulletin is to promote correct and uniform application of the tax laws by Internal Revenue Service employees and to assist taxpayers in attaining maximum voluntary compliance by informing Service personnel and the public of National Office interpretations of the internal revenue laws, related statutes, treaties, regulations, and statements of Service procedures affecting the rights and duties of taxpayers. Therefore, issues and answers involving substantive tax law under the jurisdiction of the Internal Revenue Service will be published in the Internal Revenue Bulletin, except those involving:

(a) Issues answered by statute, treaty, or regulations;

(b) Issues answered by rulings, opinions, or court decisions previously published in the Bulletin;

(c) Issues that are of insufficient importance or interest to warrant publication;

(d) Determinations of fact rather than interpretations of law;

(e) Informers and informers' rewards; or

(f) Disclosure of secret formulas, processes, business practices, and similar information. Procedures affecting taxpayers' rights or duties that relate to matters under the jurisdiction of the Service will be published in the Bulletin.

(iv) [Reserved].

(v)(a) Rulings and other communications involving substantive tax law published in the Bulletin are published in the form of Revenue Rulings. The conclusions expressed in Revenue Rulings will be directly responsive to and limited in scope by the pivotal facts stated in the revenue ruling. Revenue Rulings arise from various sources, including rulings to taxpayers, technical advice to district offices, studies undertaken by the Office of the Assistant Commissioner (Technical), court decisions, suggestions from tax practitioner groups, publications, etc.

(b) It will be the practice of the Service to publish as much of the ruling or communication as is necessary for an understanding of the position stated. However, in order to prevent unwarranted invasions of personal privacy and to comply with statutory provisions, such as 18 U.S.C. 1905 and 26 U.S.C. 7213, dealing with disclosure of information obtained from members of the public, identifying details, including the names and addresses of persons involved, and information of a confidential nature are deleted from the ruling.

(c) Revenue Rulings, other than those relating to the qualification of pension, annuity, profit-sharing, stock bonus, and bond purchase plans, apply retroactively unless the Revenue Ruling includes a specific statement indicating, under the authority of section 7805(b) of the Internal Revenue Code of 1954, the extent to which it is to be applied without retroactive effect. Where Revenue Rulings revoke or modify rulings previously published in the Bulletin the authority of section 7805(b) of the Code ordinarily is invoked to provide that the new rulings will not be applied

retroactively to the extent that the new rulings have adverse tax consequences to taxpayers. Section 7805(b) of the Code provides that the Secretary of the Treasury or his delegate may prescribe the extent to which any ruling is to be applied without retroactive effect. The exercise of this authority requires an affirmative action. For the effect of Revenue Rulings on determination letters and opinion letters issued with respect to the qualification of pension, annuity, profit-sharing, stock bonus, and bond purchase plans, see paragraph (o) of § 601.201.

(d) Revenue Rulings published in the Bulletin do not have the force and effect of Treasury Department Regulations (including Treasury decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose. No unpublished ruling or decision will be relied on, used, or cited, by any officer or employee of the Service as a precedent in the disposition of other cases.

(e) Taxpayers generally may rely upon Revenue Rulings published in the Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published Revenue Ruling to the facts of their particular cases. However, since each Revenue Ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. They should consider the effect of subsequent legislation, regulations, court decisions, and revenue rulings.

(f) Comments and suggestions from taxpayers or taxpayer groups on Revenue Rulings being prepared for publication in the Bulletin may be solicited, if justified by special circumstances. Conferences on Revenue Rulings being prepared for publication will not be granted except where the Service determines that such action is justified by special circumstances.

(vi) Statements of procedures which affect the rights or duties of taxpayers or other members of the public under the Code and related statutes will be published in the Bulletin in the form of Revenue Procedures. Revenue Procedures usually reflect the contents of internal management documents, but, where appropriate, they are also published to announce practices and procedures for guidance of the public. It is Service practice to publish as much of the internal management document or communication as is necessary for an understanding of the procedure. Revenue Procedures may also be based on internal management documents which should be a matter of public knowledge even though not necessarily affecting the rights or duties of the public. When publication of the substance of a Revenue Procedure in the Federal Register is required pursuant to 5 U.S.C. 552, it will usually be accomplished by an amendment of the Statement of Procedural Rules (26 CFR Part 601).

(vii)(a) The Assistant Commissioner (Technical) is responsible for administering the system for the publication of Revenue Rulings and Revenue Procedures in the Bulletin, including the standards for style and format.

(b) In accordance with the standards set forth in subdivision (iv) of this subparagraph, each Assistant Commissioner is responsible for the preparation and appropriate referral for publication of Revenue Rulings reflecting interpretations of substantive tax law made by his office and communicated in writing to taxpayers or field offices. In this connection, the Chief Counsel is responsible for the referral to the appropriate Assistant Commissioner, for consideration for publication as Revenue Rulings, of interpretations of substantive tax law made by his Office.

(c) In accordance with the standards set forth in subdivision (iv) of this subparagraph, each Assistant Commissioner and the Chief Counsel is responsible for determining whether procedures established by any office under his jurisdiction should be published as Revenue Procedures and for the initiation, content, and appropriate referral for publication of such Revenue Procedures.

Appendix G

Section 29.23(b)-1: Interest.

(Also Section 43, Section 29.43-2.)

1945-11-12050

I.T. 3740

INTERNAL REVENUE CODE

Where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid, but where the accrual basis of accounting is used in reporting income, interest is deductible for the year in which the liability to pay accrues regardless of when payment is actually made.

Advice is requested whether interest paid in advance for a period of five years is deductible for Federal income tax purposes for the year in which paid or whether such interest must be prorated and deducted over the 5-year period.

Section 23(b) of the Internal Revenue Code provides that in computing net income there shall be allowed as a deduction:

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness * * *

Section 43 of the Code provides in part as follows:

> SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.
>
> The deductions * * * provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions * * * should be taken as of a different period. * * *

Section 29.43-2 of Regulations 111 provides in part as follows:

> SEC. 29.43-2. WHEN CHARGES DEDUCTIBLE.—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. * * *

It is held that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements basis, interest paid in advance for a period of five years constitutes an allowable deduction for Federal income tax purposes for the year in which paid, but where the accrual basis of accounting is used in reporting income, interest is deductible for the year in which

the liability to pay accrues regardless of when payment is actually made. (See *John D. Fackler* v. *Commissioner*, 39 B. T. A., 395, acquiescence, C. B. 1939-1 (Part 1), 11, and *Court Holding Co.* v. *Commissioner*, 2 T. C., 531, acquiescence, C. B. 1943, 5; cf. G. C. M. 23587, C. B. 1943, 213.)

Appendix H

The Revenue Service has reconsidered its position with respect to the taxable year of deduction of prepaid interest by cash method taxpayers; I.T. 3740 revoked.

SECTION 163.—INTEREST

26 CFR 1.163-1: Interest deduction in general.
(Also Sections 446, 7805; 1.446-1,301.7805-1.)

Rev. Rul. 68-643[1]

Reconsideration has been given to I.T. 3740, C.B. 1945, 109, concerning the question whether interest paid in advance is deductible for Federal income tax purposes for the year in which paid.

I.T. 3740 was based upon a transaction in which the taxpayer paid interest in advance for a period of five years. As to such transaction, I.T. 3740 holds that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements method of accounting, interest paid in advance for a period of 5 years is deductible for the year in which paid, but where the accrual method of accounting is used for reporting income, interest is deductible for the year in which the liability to pay accrues irrespective of when payment is actually made.

Section 163 of the Internal Revenue Code of 1954 provides, in general, that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

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[1]Also released as Technical Information Release 1001, dated November 26, 1968.

Section 446(a) of the Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) of the Code provides, in part, that if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

As to taxpayers employing the accrual method of accounting, consistent with the position stated in I.T. 3740, interest accrues ratably over the period of the loan and is allowable as a deduction ratably over this period, irrespective of when paid.

In view of certain abuses which have arisen with respect to prepayment of interest by taxpayers using the cash receipts and disbursements method of accounting, the Service has reexamined its position in I.T. 3740. The Service now concludes that the deduction of prepaid interest in the year of payment by a taxpayer employing the cash receipts and disbursements method of accounting may not result in a clear reflection of income for the taxable year of payment. A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted. Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for

prepayment, and the existence of a varying rate of interest over the term of the loan. If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved.

In view of the foregoing, I.T. 3740 is revoked. However, pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will be applied without retroactive effect to interest prepayments for periods not in excess of five years made prior to November 26, 1968 by taxpayers employing the cash receipts and disbursements method of accounting. This Revenue Ruling also will be applied without retroactive effect to an interest prepayment for a period not in excess of five years made on or after November 26, 1968, by a taxpayer employing the cash receipts and disbursements method of accounting, pursuant to a legal obligation incurred prior to such date to make such prepayment.

The Service will no longer follow the contrary decisions in *John D. Fackler* v. *Commissioner*, 39 B.T.A. 395 (1939), acquiescence, C.B. 1939-1 (Part I), 11 and *Court Holding Co.* v. *Commissioner*, 2 T.C. 531 (1943), acquiescence, C.B. 1943, 5. Acquiescence in each of those court decisions is being withdrawn and nonacquiescence substituted therefor.
See page 3, this Bulletin.

Opposition

Office - Supreme Court, U.S.
FILED
OCT 7 1981
ALEXANDER L. STEVAS
CLERK

No. 81-348

In the Supreme Court of the United States

OCTOBER TERM, 1981

HARRY T. HOLGERSON, JR., AND MARY E. HOLGERSON,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Solicitor General
Department of Justice
Washington, D.C. 20530
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In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-348

HARRY T. HOLGERSON, JR., AND MARY E. HOLGERSON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In this federal income tax case, petitioner[1] seeks review of the decision below holding that the Commissioner did not abuse his discretion under Section 446(b) of the Internal Revenue Code of 1954 (26 U.S.C.), in determining that petitioner's current deduction of substantial amounts of prepaid interest did not clearly reflect his income.

The pertinent facts may be summarized as follows: Petitioner was in the business of buying and selling used airplane parts. During 1967-1969, he experienced a substantial increase in his income from that business (Pet. App. D-3). Aware of potential income during those years (*ibid.*), petitioner entered into five year-end transactions involving the prepayment of interest, three of which are at issue here.

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[1] "Petitioner" refers to Henry T. Holgerson, Jr. Mary E. Holgerson is a party solely because she filed a joint return with her husband for the taxable year at issue.

In the first transaction, petitioner agreed with Walnut Growers, Incorporated (Walgro), to purchase approximately 631 acres of farmland known as the Walgro property. The agreement, signed on December 13, 1967, set forth a total purchase price $1,955,250, to be paid in part by a promissory note from petitioner in the amount of $973,174.50 The agreement also set forth that petitioner was to pay to the sellers $250,000 as prepaid interest on the promissory note, and that the payment could be applied at the discretion of Walgro to any installments of interest due on that note prior to February 1, 1976 (Pet. App. D-4 to D-5). Walgro applied the $250,000 interest prepayment to the interest requirements of the note for the years 1973 through 1976 (*id.* at D-5 to D-6).

Petitioner deducted the $250,000 as interest on his 1967 income tax return (Pet. App. D-7). On audit, the Commissioner of Internal Revenue determined that only $3,350.27 was deductible in 1967, and that $68,122.22 was deductible in both 1968 and 1969. In the proceedings brought by petitioner in the United States Tax Court for redetermination of the deficiency, the Tax Court upheld the Commissioner on the ground that petitioner did not meet his burden of overcoming the Commissioner's determination that his treatment of prepaid interest did not clearly reflect his income (*id.* at D-26 & n.9). The court of appeals affirmed (*id.* at C-1 to C-2).

In the second transaction petitioner executed and mailed to Aerojet-General Corporation on November 23, 1968, an offer to purchase from Aerojet a piece of property located in Sacramento, California, known as City Annex. The offer provided that petitioner would purchase City Annex from Aerojet for $2,650,000, and that he would execute and deliver to Aerojet a promissory note in that amount secured by a deed of trust on the property. The offer further provided that petitioner would "pay an amount equal to three years in prepaid interest," at seven percent per annum (*i.e.*

$556,500), with $400,000 at closing and the balance of the prepaid interest to be paid on or before May 1, 1969 (Pet. App. D-7 to D-8).

On December 18, 1968, petitioner executed a promissory note in favor of Aerojet (Pet. App. D-11), which gave him the right to prepay the principal at any time, and further provided (*id.* at D-13):

> Interest at the rate of seven per cent (7%) per annum on unpaid principal from date of closing to and including December 31, 1971, shall be paid in advance on or before May 1, 1969. Such interest shall be based on unpaid principal as reduced by payment of regular monthly principal installments [of $10,000.00 per month] * * * to be made in discharge of unpaid principal. In the event of payment of principal derived from rental installments payable [$10,000 plus 50% of gross rentals] * * * or by reason of principal prepayments, the makers hereof shall be entitled to be credited accordingly based upon prepayments of interest computed upon principal which has not taken into account reduction in principal arising out of payment of rental installments or principal prepayments.

At closing, the promissory note was delivered to Aerojet, and $400,000 was paid to Aerojet and designated as prepaid interest on the note. Of that amount, $300,000 was paid by petitioner and the remainder was paid by certain other co-purchasers. On May 1, 1969, $156,500 was paid to Aerojet and designated as prepaid interest. Of that amount, $145,200 was paid by petitioner (*id.* at D-14).

On audit, the Commissioner allowed the $400,000 designated as prepaid interest in 1968 and the $156,500 designated as prepaid interest in 1969 to be deducted only to the extent of $5,560 in 1968 and $185,500 in 1969 (Pet. App. D-15). The Tax Court agreed with the Commissioner that the

interest prepayments must be deducted pro rata over the years during which the interest was earned. Further, the court found that petitioner did not show that the Commissioner's determinations failed to reflect income clearly (*id.* at D-30). The court of appeals affirmed (*id.* at C-1 to C-2).

In the third transaction, petitioner entered into an agreement, on December 21, 1967, to purchase the property known as Pine Terrace for $1 million from the Duffel-Smoot Companies (Pet. App. D-15 to D-16). On December 29, 1967, escrow was closed and petitioner paid the purchase price in part by a note for $274,759.03. At that time, petitioner also paid to Duffel-Smoot $150,201.52 designated as prepaid interest on the note for the period up to October 31, 1974, a period of six years and ten months. This amount was deducted in full by him on his joint return for the taxable year 1967. On audit, the Commission disallowed this deduction in his statutory notice (*id.* D-16). The Tax Court found that deducting the portion of this amount it considered interest would be a material distortion of petitioner's income in 1967. Consequently, the court held that this amount should be deducted ratably over the years for which it was paid (Pet. App. *id.* at D-35). The court of appeals affirmed (*id.* at A-1 to A-2; C-1 to C-2).

1. Section 163(a) of the Internal Revenue Code of 1954 allows as a deduction "all interest paid or accrued within the taxable year on indebtedness." But if a person prepays interest in a manner that materially distorts his income, the Commissioner has the power under Section 446(b) of the Code to disallow the deduction for the year of prepayment to the extent necessary to remedy the distortion. This authority to prevent material distortions of income has been explicitly recognized by every court of appeals that has considered the matter. *Cole* v. *Commissioner*, 586 F. 2d 747, 749 (9th Cir. 1978), cert. denied, 441 U.S. 924 (1979); *Sandor* v. *Commissioner*, 536 F. 2d 874, 875 (9th Cir. 1976); *Anderson* v. *Commissioner*, 568 F. 2d 386, 387 (5th

Cir. 1978); *Resnik* v. *Commissioner*, 555 F. 2d 634 (7th Cir. 1977); *Burck* v. *Commissioner*, 533 F. 2d 768 (2d Cir. 1976).

Here, petitioner has not challenged the Commissioner's determination that the current deductions for prepaid interest do not clearly reflect income. Rather, he claims that the deductions are permitted on the authority of the Commissioner's administrative ruling in I.T. 3740, 1945 Cum. Bull. 109, which allowed cash-basis taxpayers to deduct, in the year paid, a prepayment of interest for a period of not more than five years. But the Commissioner changed his position in Rev. Rul. 68-643, 1968-2 Cum. Bull. 76, in which he determined that if interest were prepaid for a period extending more than twelve months beyond the end of the taxable year in which the prepayment was made, the deduction of such prepaid interest in the year of payment by a cash-basis taxpayer would be a material distortion of income, and would be allowed only in the period to which it related. In issuing this ruling, the Commissioner exercised his discretion under Section 7805(b) of the Code to limit the effect of the ruling (Rev. Rul. 68-643, *supra*, at 78):

> This Revenue Ruling also will be applied without retroactive effect to an interest prepayment for a period not in excess of five years made on or after November 26, 1968, by a taxpayer employing the cash receipts and disbursements method of accounting, pursuant to a legal obligation incurred prior to such date to make such prepayment.

Petitioner argues (Pet. 21-30) that the transactions in question here have met the Commissioner's conditions limiting the ruling's retroactive effect, and that on that basis he is entitled to deduct the prepayments of interest by virtue of I.T. 3740. Indeed, his entire argument is premised on the notion that the court of appeals erred in not applying the limitation on retroactivity provided for in the ruling. To the

contrary, the opinion of the court of appeals (Pet. App. A) made clear that it simply affirmed the findings of the Tax Court. And petitioners makes no argument here, as we shall show he could not, that Rev. Rul. 68-643 was improperly applied by the Tax Court.

In the Walgro transaction, petitioners made a $250,000 prepayment of interest on December 13, 1967, which was sufficient to meet his obligations on the December 13, 1967, note for approximately three 2/3 years. He agreed with Walgro, however, that this amount could be applied, at Walgro's discretion, to any period prior to February 1, 1976. Walgro, in fact, applied the prepayment of interest to interest payments due in 1973 through 1976, a period of more than five years from the date of prepayment (Pet. App. D-5 to D-6).

Petitioner argues (Pet. 38-40) that this application of Rev. Rul. 68-643 is unreasonable. But, as the Tax Court noted (Pet. App. D-25), the proper focus should be as much on the length of the period between the date of prepayment and the date on which the prepaid interest is actually earned as it is on the number of years' interest that may be satisfied with the prepaid funds. Thus, the interest prepayment must satisfy obligations arising during a period not in excess of five years from the prepayment date in order not to be subject to the retroactive effect of Rev. Rul. 68-643. This is a reasonable interpretation, given the fact that a distortion of income results from both the extent of tax deferral and the number of years' interest that may be satisfied with the prepaid funds. Under petitioner's view, taken to its logical conclusion, he would be entitled to prepay interest (in satisfaction of five years' interest) that applies to any period, no matter how far in the future.

In the City Annex transaction, petitioner executed a promissory note in the amount of $2,650,000 on December 18, 1968, which provided that interest at the rate of seven

percent per annum on unpaid principal from date of closing to and including December 31, 1971, was to be paid on or before May 1, 1969. Pursuant to the note, prepaid interest of $400,000 was paid on December 20, 1968, and $156,500 was paid on May 1, 1969. But the principal amount upon which the prepayment was computed was indefinite, because there were various provisions in the promissory note in which petitioner was required to, and, in his discretion, could reduce the principal amount of the note during the three-year period following its execution. Thus, the prepayment was for an indefinite period, and does not fall within the language of the exception to the retroactivity of Rev. Rul. 68-643 (Pet. App. D-11 to D-15).

In the third transaction, petitioner purchased the rental property known as Pine Terrace for a stated price of $1 million. A portion of that purchase price was petitioner's note in the face amount of $274,759.03. On December 29, 1967, petitioner paid the seller $150,201.52, designated as prepaid interest on that note to October 31, 1974, a period of six years and ten months. Thus, the limitation on retroactivity provided for in Rev. Rul. 68-643 is not applicable to the prepaid interest in this transaction (Pet. App. D-15 to D-16).

2. Finally petitioner argues (Pet. 30-37) that the issue presented involves an important question of law. To the contrary, it is increasingly unlikely that controversies arising from prepaid interest deductions will persist. In 1976, Congress enacted Section 461(g) of the Code (added by Section 208(a) of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1541), which requires a cash-basis taxpayer to charge prepaid interest to capital account, and to deduct the prepaid interest in the period in which (and to the extent that) the interest represents a charge for the use of forbearance or borrowed money during each taxable year. This rule generally applies to amounts paid after December 31, 1975, in taxable years ending after that date. Section 208(b),

90 Stat. 1542 (Section 461 note of the Code). The administrative importance of this issue will accordingly diminish in future years.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

OCTOBER 1981

DOJ-1981-10

Petitioner's Reply Brief

Office Supreme Court, U.S.
FILED
OCT 23 1981
ALEXANDER L. STEVAS,
CLERK

No. 81-348

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1981

HARRY T. HOLGERSON, JR.
AND MARY HOLGERSON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE PETITIONERS IN REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

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TABLE OF AUTHORITIES CITED

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Respondent tries to dismiss petitioners' petition for certiorari on two erroneous and misleading grounds: (1) that the Ninth Circuit simply affirmed the decision of the United States Tax Court (which is untrue) and that the petitioners do not (which is again untrue) and cannot argue that the Tax Court misapplied or failed to apply Revenue Ruling 68-643; and (2) that the issue raised by petitioners is one of diminishing significance. The arguments are patently wrong and fail to address the heart of petitioners' argument, which goes to the fair and effective administration of the federal tax laws. The very weakness of the respondent's arguments is added justification for the granting of the petition to decide an issue of long-standing and continued importance in the interpretation of the revenue laws.

1. After petitioners pointed out to the Ninth Circuit the utter inconsistency of its various decisions dealing with the authority of Revenue Rulings, it changed its first opinion (Pet. App. C) to one which simply affirmed the decision of the Tax Court (Pet. App. A). However, this affirmance did not avoid the issue. As petitioners argued at length in their petition for certiorari (pp. 38 to 45), the Tax Court itself misapplied Revenue Ruling 68-643.

2. Petitioners acknowledge that the issue of the deductibility of prepaid interest is of decreasing significance after the enactment of Section 461(g) of the Internal Revenue Code. The issues presented by the petitioners, however, are of broader significance: Can the Commissioner of Internal Revenue be allowed to ignore

revenue rulings published pursuant to his discretionary authority under Section 446(b) and made nonretroactive pursuant to his power under Section 7805(b) of the Internal Revenue Code? These issues will continue to recur as long as the Commissioner of Internal Revenue, as the delegate of the Secretary of the Treasury, has the authority to prescribe discretionary revenue rulings and to determine their retroactive effect. For example, only in the last year, the Commissioner of Internal Revenue has issued Treasury Regulations under Section 385 of the Internal Revenue Code and a Revenue Ruling on industrial revenue bonds (Advance Revenue Ruling 81-216, I.R.-81-98), which state that they will be applied without retroactive effect. What weight can be given to these statements of nonretroactivity in

light of the Commissioner's actions in this and similar cases?

For the reasons set forth in the petition for certiorari and in this reply to the respondent's memorandum of opposition, the petition for certiorari should be granted.

DATED: October 22, 1981

Respectfuly submitted,

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